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# **European Business Interests in Lebanon: An Assessment of EU Private Foreign Direct Investment in the Reconstruction Era**

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**Ali Moussa Khalil**

**PhD Thesis**

**University of Durham  
Centre for Middle Eastern and Islamic Studies**

**2000**



**13 JUL 2001**

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## **Dedication**

*To my parents... for  
their unlimited support*

## **Acknowledgements**

Although the rights for this thesis rest with myself, I can sincerely testify that without the invaluable contributions of many others, this work would have not seen the light. Right at the top of the list of contributors comes my supervisor, Dr. Emma Murphy, whose support and guidance are beyond appreciation. I will always be short of words to thank her for the immense help with which she backed me, particularly, when the PhD-frustration symptoms threatened to become overwhelming.

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## **List of Abbreviations**

<b>AASMM</b>	Association of African States, Madagascar, and Mauritius
<b>AFESD</b>	Arab Fund for Economic and Social Development
<b>B.O.T</b>	Build. Operate. Transfer
<b>CDR</b>	Council for Development and Reconstruction
<b>D.B.O.T</b>	Design. Build. Operate. Transfer
<b>EC</b>	European Community
<b>ECU</b>	European Currency Unit
<b>EDL</b>	Electricité du Liban
<b>EFTA</b>	European Free Trade Area
<b>EIB</b>	European Investment Bank
<b>EU</b>	European Union
<b>EUA</b>	European Unit of Account
<b>FDI</b>	Foreign Direct Investment
<b>GATT</b>	General Agreement on Trade and Tariffs
<b>GDP</b>	Gross Domestic Product
<b>GMP</b>	Global Mediterranean Policy
<b>IDAL</b>	Investment Development Authority of Lebanon
<b>KFAED</b>	Kuwaiti Fund for Economic Development
<b>LDC</b>	Less Developed Countries
<b>MNC</b>	Multi-National Corporation
<b>NMP</b>	New Mediterranean Policy
<b>O.T</b>	Operate. Transfer
<b>OCT</b>	Overseas Countries and Territories
<b>PLO</b>	Palestine Liberation Organisation
<b>PM</b>	Prime Minister
<b>PSP</b>	Progressive Socialist Party
<b>TMC</b>	Trans-Mediterranean Countries
<b>TNC</b>	Trans-National Corporation
<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>VAT</b>	Value Added Tax
<b>WTO</b>	World Trade Organisation

## **Note on Transliteration**

Very few Arabic names and terms have been referred to in this thesis. Rather than adopting a formal system of transliteration, I have therefore transcribed names using the most commonly used formats.

## **Abstract**

The flow of foreign direct investment has long been regarded as the main engine of growth in developing countries. Lebanon has aimed at attracting foreign direct investment to contribute to its economic recovery in the post-civil war period. EU countries were expected to be a major source of investment inflows, partly, due to their rich historical relationship, and partly, as an expected result of the new Euro-Med approach, adopted in the 1990s.

This thesis assesses the EU private business interests in Lebanon during the reconstruction period, and investigates to what extent EU business engagements involved FDI. Within this framework, this thesis examines the role of the EU in encouraging the flow of EU private investments into Lebanon. This thesis falls into two parts. The first assesses the history of economic relations between Lebanon and Europe in the modern period, and the development of these relations after the establishment of the EC, examining the role of the latter in reshaping these relations. It also assesses the development of the Lebanese economy since independence from France. In the second part of the thesis, the theoretical framework of FDI is applied to a survey of EU private businesses operating in Lebanon. This helped in answering two questions: what business activities did involve FDI, and why EU firms engagement in FDI was very shallow.

The thesis concludes that the lack of FDI activities in Lebanon, whether EU or non-EU, was a result of the lack of comparative location-specific advantages. It also suggests that the Lebanese government should assume a stronger role in improving Lebanon's comparative advantages in order to attract FDI. The EU should provide substantial help – within the Euro-Med approach – to encourage EU private business investments in the country.



## **Introduction**

Economic relations with the countries of the EU are rooted in the modern history of Lebanon. The influential political position that the European powers achieved in the ailing Ottoman Empire allowed for the flourishing of European trade with the Levant region as well as encouraging some European investments, notably from France. The independence of Lebanon in 1943, and the establishment of the European Community in 1957, have given these relations new perspectives. However, like the majority of southern Mediterranean countries, Lebanon has found that its relations with Europe have primarily taken the form of a largely one-way flow of trade. Europe has exported its goods to Lebanon, but by and large has not matched these with either imports from Lebanon or private foreign direct investment into its economy.

Hopes were raised that this relationship could be altered in Lebanon's favour when the post-civil war reconstruction plan of 1993 envisaged a substantial role for the private sector in the process of economic regeneration. Foreign direct investment was considered to be vital to this process and it was anticipated that such investment would be forthcoming as the government took a lead in the rehabilitation of the economy and its infrastructure.

This thesis examines whether this has indeed been the case. By surveying and analysing the nature of the business activities of EU firms in Lebanon in the period 1993-98, (during which the architect of reconstruction, Prime Minister Rafiq Hariri, held office), the thesis is able to identify the nature, extent and limitations of private FDI originating from EU countries. The thesis shows that, despite early optimism, the bulk of such business activity has been in contracting, trade and service provision, rather than in direct investment. Using criteria drawn from various theories of FDI, most notably Dunning's Eclectic Model, the thesis shows that the reasons for this reluctance lie in Lebanon's lack of location-specific advantages. The limited size of the market, the high costs of factors of production, the failure to establish a suitable legal framework for investment, the prevalence of red-tape, bureaucracy and corruption, and continuing economic and political instability all combine to make Lebanon a relatively unattractive destination for FDI.



Lebanon might have, indeed to some extent did, expect that its past positive and prosperous relations with the countries of Europe, and the growing interest of the EU in assisting the development of the states of the southern Mediterranean, might have encouraged European private firms to invest in the rejuvenated economy. The thesis demonstrates, however, that the policies and programmes of the EU and European governments have so far done little to encourage investment in Lebanon, although they have provided some direct financial support for the reconstruction programme, which had provided some opportunities for EU contracting firms.

The thesis concludes with suggestions as to how the Lebanese government can act to offset the current lack of location-specific advantages. It also points out that progress with the EU's Barcelona process may yet provide some encouragement for European FDI in Lebanon.

Despite a wealth of literature on Lebanon's politics and, to a lesser extent, economics, very little has been said before now on foreign investments in Lebanon. Thus, while secondary sources were used for providing the historical background and the theoretical chapters, the thesis has relied on primary sources to construct the survey of EU business activities in Lebanon. These have included Arabic and English newspapers, government publications and special reports. However, the main primary source used in the thesis was the interviews conducted by the author in Lebanon and the UK. Interviewees included representatives of EU firms operating in Lebanon, Lebanese economists and government officials, and representatives of business organisations. It has to be pointed out that statistics were very difficult to obtain and, in some instances, impossible. The civil war of Lebanon has left the government statistics departments out of order. No adequate statistics on FDI in Lebanon were available. The researcher has therefore compiled many of the statistics included in the thesis himself.

The thesis is divided into two parts: the first falls into three chapters while the second part includes four chapters. In chapter one, I assess the economic relations between Lebanon and Europe in the modern period. The aim of this chapter is to investigate the development of an economic interest in Lebanon on the part of European powers, and how it fell within their wider regional interests. Through this chapter I follow the development of private European business interests that occurred during the second half of the 19<sup>th</sup> century and developed with the establishment of the French mandate. In

chapter two, I examine the impact of the establishment of the European Community on economic relations with Lebanon, and in particular on the flow of trade and capital from the member-states. This chapter also assesses whether the EU has more recently played an important role in encouraging direct investment activities by EU firms in Lebanon, concluding with an assessment of the recent Barcelona process.

Chapter three gives a detailed picture of developments in the Lebanese economy during the post-independence, civil war and reconstruction periods. In this chapter, I set the scene for the research by making the reader aware of the characteristics of the Lebanese economy and the environment which awaits potential foreign direct investments from the EU or elsewhere.

The second part of this thesis focuses on the issue of foreign direct investments in Lebanon during the researched period. In chapter four, I state the theoretical approach I have adopted in examining the activities of EU firms in Lebanon. Using theories of foreign direct investment, I determined a set of criteria with which to consider the overseas activities of a firm as FDI.

Chapter five includes a survey of EU firms that operated in Lebanon during the researched period (1993-98). The aim of this chapter is to categorise business interests of EU firms in Lebanon, and the representation of Member states amongst these firms. This chapter highlights the major business activities of EU firms, particularly projects related to the reconstruction process. This chapter shows that European firms were mainly interested in contracting, and to a lesser extent, finance and trade. Firms from EU countries got a majority of the contracts tendered by the government to rehabilitate the devastated infrastructure of the country. It showed also that French firms were the most highly represented amongst other EU-nationalities.

In chapter six I take the research further by looking at specific case studies of EU firms that operated in Lebanon during the researched period. I chose firms from the three sectors that proved most popular amongst EU firms, in the previous chapter. I use the criteria extracted from the theories of FDI to examine the operations of these chosen EU firms. Chapters five and six show that FDI activities did not score highly amongst the interests of EU firms operating in Lebanon.

Chapter seven attempts to answer why there was a scarcity of FDI activities by EU firms. Just as I used the theories of FDI to, in the previous chapter, investigate whether EU firms were investing in Lebanon, I use the theories here to explain why they were not investing in Lebanon. The result of this research revealed that Lebanon did not provide competitive location-specific advantages to attract foreign direct investments from the EU, or other potential sources of FDI.

The thesis ends with a conclusion in which I suggest ways in which the Lebanese government can act to counter the absence of location-specific advantages. I also suggest areas for further research. The thesis thus has prescriptive value and makes a contribution to the understanding of both academics and policy-makers.

# PART ONE

## **Chapter One: Historical Relations between Europe and Lebanon**

*"There had been a 'Sheikh Francis' in every generation since the Sixteenth century, since the day Suleyman the Magnificent had granted the King of France [Francis] the right to keep an eye on the fate of the minorities in the Levant, as well as the Holy sites, and the French king had written to the chiefs of the great families in the Mountains assuring them of his protection. Amongst these recipients was one of our Sheikh's ancestors. He is said to have received the message the day his first child was born. The child was immediately christened Francis"*

*Amin Maalouf, "The Rock of Tanios"*

### **1.1 Introduction**

The aim of this chapter is to establish the historical background of economic relations between European businesses and Lebanon. The chapter shows the extent of Lebanon's importance to European powers and businesses during the last two centuries. The discussion starts with the regional context of European economic interests in the Middle East and then spotlights specific interests in Lebanon. It will also serve to contextualise the dynamics of contemporary European business relations with Lebanon, and help to identify the position of Lebanon on the map of European business interests in a regional context.

It is quite difficult to trace the very beginning of relations between Europe and the Middle East. They can be traced back to the twelfth-century Crusades, when friendship and alliances were established between the Maronites of Mount Lebanon and the "Frankish invaders".<sup>1</sup> During the same century, in 1180, the Maronite church was united with Rome.<sup>2</sup> By the fifteenth century, clerics from the Maronite church were being sent to study in Rome. Relations can be traced also to 1535, when Francis I arranged a treaty with Suleiman the Magnificent, giving France capitulatory privileges in the Ottoman Empire. France then strengthened its power in the Middle East, mainly Syria, as it declared itself the protector of the Maronites, as they were part of the Catholic Church to which France belonged and of which France was then the most significant power.

My concern in this chapter is European relations with the Middle East in the modern era although it is difficult to separate more recent developments from their historical context. Modern relations between the Middle East and Europe began with Napoleon's

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<sup>1</sup> Meo. Leila M. T, Lebanon Improbable Nation: A study of political development (Bloomington: Indiana University Press, 1965) p. 25.

invasion of Egypt in 1798. An extension of the war between Britain and France, the French occupation of Egypt and the subsequent attempt to occupy Syria (both parts of the Ottoman Empire at the time) led to an alliance between Britain and the Ottomans, forcing the French to retreat. This alliance was the first between the Ottoman Empire and a non-Muslim state.<sup>3</sup> Moreover, already by the end of the eighteenth century, the Ottoman Empire (or the “World of Islam”, as Kamal Salibi calls it<sup>4</sup>) was seriously conscious of the impact of European penetration. The Ottomans were impressed by the superiority of the European armies who had defeated them many times since the seventeenth century. They realised that some European methods of development should be adopted in order to meet the European challenge.<sup>5</sup>

## **1.2 European interest in the Middle East in the 19th century**

The interests of European powers in the Middle East region were a combination of political, strategic and economic. Although different, these interests were in many cases very much interrelated. The relations with the Ottomans varied from one European power to another due to differences in interest. The more that relations with the Ottoman Empire were beneficial to European power's supremacy, the more these powers were interested in developing it. Accordingly, there were many conflicts among the European powers in the region due to the competition to gain more privileges from the Ottomans. These conflicts, supported sometimes by the Ottomans themselves, caused fluctuations in European powers' influence in the region. France, for instance, had significant privileges in the Ottoman Empire in the eighteenth century, both political and commercial. However, when Napoleon occupied Egypt, where he was later defeated, the French lost all these privileges to their rivals, the British, who had allied themselves with the Ottomans.

Napoleon's defeat in 1814 ended the French obstruction of British policy in the Ottoman Empire. Britain had now secured its supremacy in the Levant, the Persian Gulf, the Red Sea and Southern Arabia. Moreover, the trade routes to India and the Far East were secured. No threat could come except from Russia, which helped both Britain and the Ottomans against France and accordingly strengthened its position. Britain's

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<sup>2</sup>Hourani. A, *A History of the Arab Peoples* (Cambridge, Mass: Belknap, 1991) p. 265.

<sup>3</sup>Hourani. A, *op.cit.*, p. 265.

<sup>4</sup>Salibi. K, *The Modern History of Lebanon* (1965) p. 120.

concern over Russian influence stemmed from the latter's interests in Iran, which was close to the British Empire in India.<sup>6</sup>

The British interest in the Middle East in the first half of the nineteenth century had both strategic and economic aspects. As the Committee of Imperial Defence observed, the British Empire was "naval, Indian, and colonial".<sup>7</sup> Therefore, the routes to the British Empire in India were to be protected and the Middle East was the main land route to it. The southern route to India that goes around Africa was already protected by the British existence in South Africa. This British anxiety about India made it keen not to allow any threat to the weak Ottoman Empire, which worked as a buffer zone between ambitious Russia and British India. British commercial interest lay in Egypt, as the British textile industry became dependent on Egyptian cotton, especially after the cut in supply from America during the American civil war.<sup>8</sup> However, the Middle East did not represent just a source of raw materials for Britain. On the contrary, it became a significant market. Between 1815 and 1850, British exports to the Eastern Mediterranean increased by 800 per cent, by which time Bedouins in the Syrian desert were wearing shirts made of Lancashire cotton, as Albert Hourani noted.<sup>9</sup>

French interests in the Middle East appeared to be predominantly cultural. Being a Catholic power, France introduced itself as the protector of the Catholics in the Ottoman Empire. French Jesuits established their missions in Syria (contemporary Lebanon included), and special relations, going back to the twelfth century, were developed with the Maronites. However, French interests were by no means restricted to the cultural arena only. Back in the eighteenth century, the French privileges acquired from the Ottomans established a prosperous commercial relationship between France and the Middle East. At that point in time French trade with the region flourished while other European trade, British in particular, was in decline. Well over half the sea-borne trade was controlled by the French merchants of Marseilles. French exports of woollen cloth, for instance, were more in demand in the Middle East than other European products because they were thinner, lighter and softer, and therefore more suitable to Middle

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<sup>5</sup> Salibi. K (1965) op.cit, p.120.

<sup>6</sup> Peretz, D, The Middle East Today (New York: Holt, Rinehart & Winston, 1963) p. 89.

<sup>7</sup> Ismael. T, The Middle East in World Politics: a Study in Contemporary International Relations (New York: Syracuse University Press, 1974) p. 22.

<sup>8</sup> Peretz, D, op.cit, p. 98.

<sup>9</sup> Hourani. A, op.cit, p. 267.



Eastern use. The French had an additional advantage in that their manufacturers provided steady markets for most of the primary products then exported from the Middle East, especially short-staple cotton.<sup>10</sup> However, this French supremacy in the Middle East was to collapse by the end of the eighteenth century with the beginning of Napoleonic wars. Owen has pointed out that the French trade in the Mediterranean was almost entirely destroyed, first by the restrictions imposed on exports by the Convention in 1793, and then by the command of the sea exercised by the British fleet after the battle of the Nile (1798). French merchants living in Istanbul, Izmir, and along the Syrian coast were either imprisoned or forced to flee as soon as their country commenced hostilities against the Ottoman Empire, losing most of their assets in the process. This was a great victory for Britain, as it expelled not only the French merchants from the Mediterranean but also all Napoleon's allies including the Dutch, Austrians and Italians. This development was to be accompanied by the first stages of the industrial revolution in the Britain.<sup>11</sup>

Russian interest in the Ottoman Empire was confined to securing a maritime route to the warm waters of the Mediterranean through the Straits of the Bosphorous and Dardanelles. Also, they were keen to keep other powers' fleets out of the Black Sea. Those interests incited the Russians to seek superiority in the region, once through negotiations with the Ottomans, and another time through using military power to occupy the region. However, when Russia declared war against the Ottoman Empire, in 1877, and its army tried to advance towards Istanbul, Britain stood by the Ottomans' side. It was clear that no European power would allow any attempt to dismantle the Ottoman Empire by another.<sup>12</sup> A separate and notable Russian interest in the Middle East was in Palestine, as Russia tried to appear as the protector of the Orthodox Christians. However, no significant Russian commercial interest in the Middle East occurred in the first half of the nineteenth century.

Germany did not show any particular interest in the Middle East before 1890. Under Bismark, German concern was directed towards more pressing European problems. He preferred not to challenge the British and French in Africa and Asia, unless this

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<sup>10</sup> Owen. R, The Middle East in the World Economy, 1800-1914 (London: Methuen, 1981) p. 83.

<sup>11</sup> Ibid.

<sup>12</sup> Hourani. A, op.cit, p. 279.

challenge would strengthen Germany's position in Europe, while he left the Balkans and Middle East to the manoeuvres of his Austrian and Russian allies.<sup>13</sup>

Accordingly, the majority of European trade with the Middle East in the first half of the nineteenth century was British. The interruption of French trade with the Middle East opened the way for the increasing output of British manufactured goods. The Middle Eastern market gained significant importance for the British, as it became the alternative destination for their goods that were banned from entering several European markets due to the war with Napoleonic France. With regard to the enormous increase in factory-produced goods for example, cotton textiles increased from some £10 million at the beginning of the wars with France to some £30 million at the end, clearly showing the importance of the Middle East as an alternative market.<sup>14</sup> British exports to the Levant were valued at £300,000 by 1816, the first year after war. Two years later, at the peak of the post-war boom, the value of these exports had increased to £800,000. Cotton goods contributed to more than half of the total sum of British exports in both periods, valued at £190,000 and £550,000 respectively. Until 1845-9 British exports to the Middle East averaged more than £3,000,000 a year. By this same period, Turkey, Egypt, and Africa provided 14 per cent of the world market for British cotton piece goods.<sup>15</sup>

On the other side of the Mediterranean, France started establishing for itself an influential role in the Maghreb. In 1830, French troops occupied Algiers. Economic incentives were behind this invasion. Due to economic growth, the French merchants of Marseilles wanted a strong trading position on the Algerian coast.<sup>16</sup> The occupation of Algeria was the first step to controlling the Maghreb, as will be discussed later in this section. However, France did not neglect the Eastern Mediterranean and tried to re-establish its links with it. This process took the French a number of years. In the 1840s, French trade with the Eastern Mediterranean was strengthened again, at the same time as the industrial revolution in France. The need for raw materials increased trade between France and the Middle East. Silk and cotton were imported from Izmir in the 1830s, later on challenged by Beirut and Alexandria as they became the most notable ports for silk and long-staple cotton respectively.<sup>17</sup>

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<sup>13</sup> Peretz. D, op.cit, p.100.

<sup>14</sup> Owen. R, op.cit, p. 84.

<sup>15</sup> Ibid.

<sup>16</sup> Hourani. A, op.cit. p. 260.

<sup>17</sup> Owen. R, op.cit. p. 86.

Once again, British trade was rivalled by the French who, with the Austrians, revived their sea-borne trade with the Middle East. Owen argues that the “total value of the sea-borne trade of these two countries with the Middle East was just under £2,000,000 (compared with Britain’s £2,500,000) in 1840/1 and about £3,500,000 (as compared to Britain’s £6-6,500,000) at the end of the same decade. In the case of Austria, he adds, these figures exclude the important overland trade, which in the early 1840s may have been worth another £2,000,000.”<sup>18</sup>

One of the main reasons for this prosperity in European trade with the Middle East was the enormous development in transportation. With the coming of the steamship in the 1830s and 1840s, transportation became faster, safer and cheaper. The moving of goods from producing countries to markets in large quantities became easier. Regular steamship routes were established between Egypt and the Levant from 1835 onwards. Being faster than the sailing ships, the new ships allowed the merchants to move easily from one port to another looking for markets.<sup>19</sup> Issawi noted that steamships converged on the various ports of the region from several origins. Ships arriving in North African ports were mainly from France and England. Egypt, Syria, and Turkey received ships from England, France, Trieste, and Italy. Turkey received, through the Black Sea, ships coming from Russia and Austria, while the Red Sea ports and the Persian Gulf received ships from India.<sup>20</sup> The English were the first to establish steamship routes to the Eastern Mediterranean, hence travelling between Beirut and Alexandria, and from there to Liverpool became faster and more regulated. The first French steam-ship travelled from Marseilles to Constantinople in May 1837. Michel Chevalier said that this steamship route was founded to create strong links between Europe and the East. While these were initially political and moral links, they were also materialistic, “which means links of business and interest, the most important issue in our [European] positivistic life”.<sup>21</sup> Several steps were taken in Europe to strengthen the trade with the Eastern Mediterranean. France lifted the strict rules that were imposed on the French trade with eastern Mediterranean and “Berber” (North African) countries. Thus, by 1835, traders did not need to obtain previously required licenses and insurance for their trade.

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<sup>18</sup> Owen. R, op.cit. p. 86.

<sup>19</sup> Ibid. p. 89.

<sup>20</sup> Issawi. C, *An Economic History of the Middle East and North Africa*. (London: Methuen, 1982) p. 5.

<sup>21</sup> Chevalier.D, “*Mujtama’ jabal lubnan fi ‘assr a-thawrah a-sina’iyah fi oroupa*”. *The Community of Mount Lebanon in the Age of Industrial Revolution in Europe*. Arabic edition (Beirut: Annahar. 1994) p.337.

Moreover, the consulate fees of 2 per cent imposed on the goods imported from the Eastern Mediterranean to Marseilles were abolished.<sup>22</sup>

### **1.2.1 Implications of the European expansion on the region's economy**

The European commercial expansion in the Middle East in the first half of the nineteenth century had several implications for the region's economy. Firstly, the European demand for certain products, such as raw materials for industry, stimulated the expansion of the production of these crops, as they became significantly profitable products. In Egypt, cotton was the main crop as the British textile industry depended heavily on it. In Syria, silk became the predominant crop, in addition to cotton and cereals. This development reveals how the production system in the Middle East was shaped by European demand. The production cycle was increasingly controlled by European market needs, not by domestic needs.

Secondly, this connection between the European markets' demands and the Middle East supplies linked the economy of Middle Eastern regions to the world economy. Production was affected by fluctuations in the European business cycle, and the prices of the products were determined by international prices.

Thirdly, the new trade boom gave vast importance to the coastal port towns in the region. Towns like Beirut and Alexandria gained great importance at the expense of interior cities, like Damascus, which had been central to trade in the past. The European merchants did not have access to the interior areas. However, they needed to deliver their goods to the interior markets. Here the role of the coastal towns appeared. These coastal towns, later on cities, were the mediators between European trade and the interior markets. European exports spread from these cities all over the interior regions, and raw material productions were collected in these cities to be shipped later to Europe.

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<sup>22</sup>Chevalier, D, op.cit, p.340.

### **1.2.2 The second half of the 19th century: European economic control in the Ottoman Empire**

The second half of the nineteenth century witnessed growing European influence in the Ottoman Empire. Although European powers pledged to respect the independence of the Empire as they signed the Treaty of Paris in 1856, they did not refrain from interfering in the internal affairs of the Empire. However, it was obvious that no European power favoured the collapse of the Ottoman Empire. When the Russians threatened to occupy Istanbul in 1877, as was mentioned previously, Britain supported the Ottomans against Russia. The powers preferred to defend a weak and dependent Ottoman Empire as this would allow them to have privileges and concessions in the regions of the Empire.

The Middle East, as a principal route to the British Empire in India and other European colonies in the Far East, became of paramount importance after the opening of the Suez Canal in 1869. As a result, main land and sea routes needed for reaching the Far East passed through the region. This development increased the European, mainly British, interest in Egypt, as this canal would save much time and expense in reaching markets and colonies. Britain tried to control the canal to protect its marine route from being threatened by any power. Moreover, Britain tried to secure all seaways from the Red Sea to the Indian Ocean, managing to achieve this by controlling the western coasts of the Arabian Peninsula.

During the same period, European influence developed into financial interference. The Ottomans borrowed large sums of money from Europe, with the burden of the interest service and repayment becoming astronomical by 1875. In 1881, a Public Debt Administration representing foreign creditors was set up and given control over a large part of Ottoman revenues, and financial policies.<sup>23</sup> In Egypt, the situation was no better. Under Khedive Ismail, Egypt borrowed money on large scale. By 1876 it was no longer able to afford the repayments and Egypt's share in the Suez Canal was sold to the British. Eventually, the French and British got their hands on the entire financial system. Some years later, in 1882, under the pretext of protecting the legitimate authority from Ahmad 'Arabi's government, British troops occupied Egypt. Now Britain could secure its control over the Suez Canal.

Similar developments were taking place at the western end of the Mediterranean. Already established in Algeria, the French occupied Tunisia in 1881. This military interference was preceded by financial intervention when Tunisia became heavily indebted to the European banks in 1869. In Morocco, another European player appeared on the arena. Spain invaded the country in 1860, an action it took to extend its influence in the country and to oppose the spreading British one. The contrast between the European powers' policies in North Africa (Britain, France, Spain) was reconciled finally at the beginning of the twentieth century, in 1907, when France and Spain shared the control over Morocco by dividing it, while the French supremacy in the region was acknowledged by the others. Italy came late to the scene by declaring war on the dying Ottoman Empire in 1910 and occupying Libya.<sup>24</sup>

The twentieth century began with the Ottoman Empire being in an unenviable situation. Threats were coming from everywhere: Russia pushing from the North trying to have concessions in the Straits; Britain controlling Egypt, the Arabian coasts and the Persian Gulf; France having a free hand in the Maghreb; Italy occupying Libya; and the Balkan countries gradually shaking of Ottoman control. Only the heartland of the Empire, in Turkey, Syria and Iraq, was still under the Ottoman control. In short, the region was riddled with European influence. Out of all the European powers, only Germany, after Bismarck, was developing relations with the Ottoman Empire. By the end of the nineteenth century, German trade with the Ottoman Empire jumped from the 15th place to second. Britain was worried about these developments, mainly because Germany was growing as a potential threat to other European powers. This in part explains the way coalitions were formed in the First World War.

### **1.2.3 The First World War's legacy: Absolute Franco-British supremacy in the Middle East**

In the 1920s, no power could challenge the supremacy of Britain and France in the Mediterranean. The Ottoman Empire had collapsed; Germany and the Austro-Hungarian Empire were defeated; Russia became the Soviet Union and its internal issues took precedence over foreign affairs; and the US preferred isolation. Britain and France divided the Middle East between them, according to the Sykes-Picot Agreement

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<sup>23</sup> Hourani. A, op.cit, p.281.

of 1916. The French-British supremacy was recognised by the League of the Nations through the establishment of mandates over the countries that were considered unable to manage their administrations. Lebanon and Syria were put under a French mandate while Iraq, Palestine and Transjordan were put under a British mandate.

British interest in the Middle East was still concerned primarily with the production of cotton in Egypt and Sudan, the sea route to India through the Suez Canal and later the air-routes that crossed the region with Egypt as the centre, oil in Iran, which became prominent for Britain and second only in importance as a source of oil to the Caribbean (Iraq also became a source of oil later on, however, it was not as important as Iran), investments all over the region, mainly in Egypt, and markets for British manufactured goods.

The French showed great interest in the Maghreb during the same period. A source of manpower for the army, and containing a significant French community, in addition to being a source of important raw materials and markets, the Maghreb received remarkable attention. The French commenced building roads, railways, and generating electricity, while on the other hand, they were exploiting the natural resources of phosphates and manganese.<sup>24</sup> In the Middle East, Hourani argued that the French interest was limited to a few investments in Lebanon and Egypt, particularly the Suez Canal, and “some degree of moral commitment to the Christians of the mandated territory”. Only the oil of Iraq became prominent to the French as by 1939 it represented half of French oil imports. Nevertheless, this does not prejudice the fact that France’s military existence in Syria and Lebanon strengthened its position in the region, and provided land and seaport bases for its army, in addition to a military air-route to its empire in Indo-China.

#### **1.2.4 World War II: major changes in the powers position in the region**

The Second World War changed the balance of power in the Middle East. The British managed to keep their influence in the region after the war while their allies, the French, were forced to abandon their mandate in the Levant. The earlier defeat of Germany had weakened the French position and forced them to accept the British desire to give the

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<sup>24</sup> Hourani. A, op.cit, p.282.

<sup>25</sup> Ibid. p.320.

promised independence to Syria and Lebanon. Germany and Italy were defeated and pushed out of the region, while American interest was just starting to develop. Only the USSR appeared as an alternative power in the Middle East.

For the USSR, the new influence it acquired revived its old ambitions for a special role in Turkey and Iran. In Turkey, the USSR was not happy with the situation in the Straits and wanted to deny the warships of non-Black Sea countries the right to get through while, on the other hand, giving those of the Black Sea countries the right to pass freely to the Mediterranean. In its effort to make this desire actual, the USSR denounced the 1925 Turko-Soviet neutrality treaty in 1945 and then claimed the rights to Turkish territories, which had been taken from the Ottomans in 1878 but returned to Turkish rule in 1921. The British and US support for Turkey made the USSR's pressure fruitless and it terminated in October 1946.<sup>26</sup> In Iran, the USSR tried to strengthen its influence in the northern provinces. It was an attempt to weaken Iran and turn it into a dependent state, in addition to exploiting its oil richness. Here also, the USSR failed, and ultimately withdrew its troops in return for oil concessions. However, these oil concessions remained on paper only and never turned into reality.

Britain, the second great power in the Middle East, wanted to maintain its influence in the region through treaties with independent states, a policy it had followed in the 1930s but which had failed in the long term. Britain's interests in the Middle East were still those of communication and oil. The Suez Canal was still a vital maritime route for British trade and war ships; air-routes to India over the Levant were also important; and Iranian oil remained prominent. Yapp has argued that the British treaties of the 1930s were replaced by British dependence on the Arab's goodwill to maintain their influence in the 1940s, hence they harvested the consequences in the 1950s.<sup>27</sup> The British interest in Iran received the final knock with the nationalisation of oil in 1951. Britain lost its refinery in Abadan (the biggest refinery in the world), its share in the oil company, and the vital oil supplement. In the Arab world, Britain failed to reach agreements with the Arab states that would guarantee the continuation of its influence in the region. This generalisation had to exclude Transjordan, where an agreement provided Britain with the right to use the military bases within the country.

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<sup>26</sup> Yapp, M, *The Near East since the First World War* (London: Longman, 1996) p.395.

<sup>27</sup> Ibid. p. 400.



Britain attempted to re-establish its influence in the region through the foundation of the Baghdad Pact in 1955. The Northern Tier states of Turkey, Pakistan, Iran and later Iraq joined together in a pact with the “purpose of military defence against the USSR”<sup>28</sup>. Britain’s anxiety about the future of its interests in the Middle East reached its climax with Nasser’s nationalisation of the Suez Canal Company in July 1952. However, the British and French military intervention to regain their control over Suez Canal hastened the demise of their influence in the region which was largely replaced by the US and Soviet. Nevertheless, the war showed the extent to which the Suez Canal was crucial to Britain’s economy as the closure of the canal blocked the way of oil shipments, and also brought Britain to an economic crisis. This was revealed in the drop in the Sterling rate - already weak before the operation - due to US pressure on Britain to withdraw from Suez. This war was the final blow to British and French influence in the Middle East. Despite the fact that the French control continued over the Maghreb, it was obvious that the Middle East was no more a region of European influence but rather an arena for American and Soviet activities.

### **1.2.5 Summary: Europe and the Middle East**

The region of the Ottoman-controlled Middle East had proved to be of significant economic interest for the European powers in the 18<sup>th</sup> and 19<sup>th</sup> centuries. The revolutionising of European industry necessitated the need for sources of raw materials and markets. The area of the Middle East that was under the Ottoman control provided all these provisions. Agricultural raw materials needed for textile industry were available, or at least had the potential to grow. Egypt became the source for cotton while Syria provided the silk. This same region that produced the raw material was also an important market for the manufactured products. Moreover, the region provided access to European colonies further afield that also possessed raw materials and markets. By establishing a stronghold in the Middle East, European powers were able to control the trade route to India and later the maritime route to oil in the Persian Gulf. It was within this framework of interests that European investments in the region had manoeuvred. Investments ranged from cotton growing in Egypt and Sudan, and silk-reeling in Syria, to the improvement of transportation (ports and railway) around the region. They invested as well in fields that strengthened the region’s dependence on Europe in

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<sup>28</sup> Yapp. M, (1996) p. 405.

foreign trade. Thus, banking systems developed rapidly in some towns providing capital for foreign trade in which imports from Europe proved to be the main component.

### **1.3 Development in the historical relations between Europe and Lebanon**

It is important to note that relations between Europe and Lebanon were very much fused with Europe's relations with Syria, as Lebanon did not exist as a separate entity before 1920. The whole area, including the current Jordan and Palestine, was referred to by Europeans as the Levant. Beirut was the sea outlet for Damascus through which trade exchange with overseas countries was conducted. However, Mount Lebanon had a peculiarity distinguishing it from other parts of Syria. The most prominent characteristic was its being predominantly a Christian Maronite enclave, to which the latter fled from other parts of Syria. The Maronites tried persistently to avoid being subjected to the Muslim authorities, of which the Ottomans had represented the latest. This might explain their decision to settle in some parts of Mount Lebanon, which served as a safe shelter from Muslim control. The hard paths of the mountain often prevented the Muslim armies from being able to subordinate them completely.

Through their persistent claim of being different from the Muslim surroundings, Maronites sought foreign protection. This was expected to come from Christian Europe, which was showing interest in the Levant. As mentioned earlier, France declared itself the protector of the Catholic Maronites after the treaty of 1535 between Francis I and Suleiman the Magnificent, which gave France the first capitulatory privileges in the Ottoman Empire.<sup>29</sup> The links between France and the Maronites developed quickly as Europe was itself witnessing enormous developments. The industrial development in Europe gave certain importance to the European relations with the Maronites as the Levant attracted the Europeans as a market for their new production.

Modern relations between Europe and Lebanon were enhanced in the first part of the 19th century, with the establishing of steamship routes between European and Eastern Mediterranean ports. Beirut, a small town on the Mediterranean between Alexandria and Izmir, which counted a population of not more than 6-7000 at the beginning of the 19th century, became the much-frequented port of Syria and the main storage deposit

for the foreign traders. Dominique Chevalier argued that Beirut's port took over the role of the two small port-towns of Tripoli and Sidon, which, in addition to Acre, attracted the bulk of commercial activities in the 18<sup>th</sup> century. It was a convenient place for the English merchants as they were seeking bases for their trade in the Eastern Mediterranean. The French occupation of Italy contributed to the English merchants' move, as it deprived them of their commercial storage in the Italian ports. The French as well were keen to look for new trade bases as their establishments in Acre, Sidon and Tripoli were corrupted by the monopolisation and blackmailing practised by the Pashas, Chevalier added. The consequences of the Egyptian expedition were another incentive.<sup>30</sup> Owen has argued that the feeling of being secure incited the European merchants to prefer Beirut due to its close proximity of the mountain to which they could withdraw in times of troubles.<sup>31</sup> Salibi and Chevalier noted that the freedom and protection that were granted by the Amirs of Lebanon made Beirut welcoming to Europeans. Thus, European consulates were moved to Beirut in the 1820s, while all super-powers' representations developed by the 1840s into general consulates. Philip Hitti stated that the city hosted several American and British missionaries and a growing number of French traders and businessmen. In addition, a bazaar of Greek and Italian shops had flourished.<sup>32</sup> Chevalier has said that ever since, Beirut's development has been linked to the European economy.<sup>33</sup> Owing to its growing importance, many other commercial centres lost their own importance to Beirut. Damascus, for instance, became dependent on Beirut. By mid-century, for example, Damascene merchants needing letters of credits had to go and obtain them from Beirut.<sup>34</sup>

### **1.3.1 European rivalries in Mount Lebanon**

The European behaviour in Mount Lebanon reflected the rivalries among them. The period of Egyptian occupation witnessed remarkable European activity showing the keenness of these powers to find or strengthen their footholds in the region. During the rebellion against the Egyptians in 1840, Britain, the ally of the Ottomans at that time,

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<sup>29</sup>Salibi.K, op.cit, p. 12.

<sup>30</sup>Chevalier. D, op.cit, p. 341.

<sup>31</sup>Owen. R, op.cit, p. 98.

<sup>32</sup>Hitti.P.K, *A Short History of Lebanon* (London: Macmillan, 1965) p. 165.

<sup>33</sup>Chevalier.D, op.cit, p.341.

Salibi.K, op.cit, p. 121.

<sup>34</sup>Owen. R, op.cit, p.98.

backed the insurgents and supplied them with arms. The British had no interest in keeping the Egyptians, who were on good terms with the French, in Syria. Russia interfered in this insurgency by supporting the rebels, mainly the Greek Orthodox. It was a step to enhance Russia's position as the protector of this Christian sect in the region. Austria did not hesitate to exploit the weakness of the French position by trying to gain the privilege of protecting the Catholics.<sup>35</sup> Indeed, European consuls started interfering in every issue related to disputes between the religious groups of Mount Lebanon. European consuls were competing for gaining guardianship over these groups. The French and the Austrians consuls were competing over the Maronites' and other Catholics' guardianship; Russian consuls managed to draw the Greek Orthodox to their side; the Druse, who until 1841 did not hold any special relations with a European power, were taken up by the British who were upset with Maronites' alliance with France. This increased the Maronites' antagonism towards the British and pushed them to throw themselves on the French side entirely.<sup>36</sup>

European trade with Syria (including contemporary Lebanon) witnessed tough competition between the French and English merchants in the 19<sup>th</sup> century. In spite of the French embarrassment in the region due to the consequences of the Napoleonic wars at the turn of the century, the French merchants managed to re-establish their business in Syria, which they had not lost entirely owing to their relations with the Maronites in Mount Lebanon. Indeed, French merchants almost held the Syrian market under their control such that it became not merely a market for their products but also a source for raw materials needed for French industry. The British attempts to take over the French role in the Levant's market incited them to look towards the interior, mainly Aleppo, which became a crossroads for British trade with India and the Persian region.<sup>37</sup> However, the scarcity of production in Syria in the first half of the 19th century made it difficult for the European merchants to find enough goods to fill their shipments on their way back to Europe. Owing to this situation, European merchants tended to collect money and precious metals like gold and silver. The English merchants were the keenest amongst their European counterparts in accumulating such metals. They also collected old Turkish currencies that were made of gold and silver. The figures show

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<sup>35</sup>Salibi.K, op.cit, p. 41.

<sup>36</sup>Salibi. K, op.cit, p.55.

<sup>37</sup>Chevalier.D, op.cit, p. 347.

Owen. R, op.cit, p. 86.

that English exports of goods to Syria in 1835 did not exceed FF 173,000 while they took out some of FF 2,000,000 of money, gold and silver.<sup>38</sup> This policy created financial problems and impoverished the region as the European products were flowing into its markets and absorbing all its financial resources.<sup>39</sup> Nonetheless, a distinction between French and British trade policies should be made. Chevalier points out that as English merchants tended to take precious metals out of the region in exchange of their goods, the French imported various raw materials, like silk and oily plants. In a way, this had a better effect on the economy but still did not cover the deficit in the balance of trade between Europe and the region.<sup>40</sup>

### **1.3.2 The prosperity of silk production: inward foreign investment**

The prosperity of silk production in Mount Lebanon owed much to the European demand for silk starting back in the seventeenth century. Carolyn Gates has argued that this European need for silk stimulated trade between Europe and Lebanon, which exported silk to France and Italy.<sup>41</sup> The next two centuries saw an increase in production following the increase in European demand, with Mount Lebanon beginning to specialise in silk production. This grew rapidly in the nineteenth century due to a surge in exports to France. Gates maintained that "Lebanon's position in the nineteenth-century international market economy was shaped by the development of sericulture" which became the engine of growth in that period.<sup>42</sup> As demand increased, it dragged the prices up with it.<sup>43</sup> Silk came second only to gold and silver on the list of exports at the beginning of the 1850s, but moved to first place in 1854.<sup>44</sup> As a result of the increase in European demand the production of silk in Mount Lebanon and Syria increased by 350 per cent between 1873 and 1902.<sup>45</sup> The dependence on the French market was obvious according to Gates who stated that 40 per cent of silk exports went to France in 1873. This figure reached 99 per cent in 1914.<sup>46</sup> The capital invested in silk production became significant, as well. The annual operating capital of the spinning

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<sup>38</sup> Chevalier.D, op.cit. p. 347.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> Gates.C. L, *The Merchant Republic of Lebanon: Rise of an Open Economy*. (London: I.B.Tauris, 1998) p. 12.

<sup>42</sup> Gates. C. L, op.cit, p. 13.

<sup>43</sup> Chevalier.D, op.cit, p. 360.

<sup>44</sup> Ibid.

<sup>45</sup> Gates. C. L, op.cit. p. 13.

factories of Mount Lebanon was estimated at FF 9 m of domestic resources, compared to FF 8-9 m of foreign resources, as Gates pointed out. Meanwhile, domestic fixed capital had an additional FF 2.3 m and foreign fixed assets reached FF 0.2 m.<sup>47</sup> Salibi pointed out that the French-built factories and the local firms' imitations employed large numbers of workers and made silk production the primary feature of Lebanon's economy at that period.<sup>48</sup> Indeed, half of the population of Mount Lebanon was economically dependent on sericulture by then.<sup>49</sup> Chevalier noted that the silk production was a two-way investment: it was a source of profit for foreign trade and the French textile industry, and opened the way for foreign capital into the region, on the one hand, but supported at the same time a domestic productive system, on the other.<sup>50</sup> The previous character of Beirut as the entrepôt of foreign exports into Damascus and interior Syria was changed due to the fact that Beirut became a silk exporter.<sup>51</sup>

However, this single commercial crop production, according to Zamir, increased the dependence on imported food and "made the *Sanjak* (Mount Lebanon) more vulnerable to crop failure in both the mountain and the neighbouring areas". Zamir added that the economy was affected, at the turn of the century, by the reduction in demand for raw silk products, which was previously the main source of income.<sup>52</sup>

The importance of silk production drew foreign direct investments into the industry. In the second half of the nineteenth century, French and British businesses established silk reeling factories in Mount Lebanon. Five of the nine factories that existed by 1852 were owned by French, while another two belonged to British firms. The number of French factories increased by 1870 to ten, while many of the old factories were modernised.<sup>53</sup> Available figures on foreign direct investment in silk industry, as mentioned earlier, suggested the engagement of FF 8-9 million of foreign capital in silk production. However, Issawi stated that foreign investments in the region of Syria up until 1914, of which the majority was French, totalled FF 500 m (Sterling 20 m).<sup>54</sup> Gates noted that

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<sup>46</sup> Gates. C. L., op.cit, p.13.

<sup>47</sup> Ibid.

<sup>48</sup> Salibi. K, op.cit, p. 116.

<sup>49</sup> Gates. C. L., op.cit, p. 14.

<sup>50</sup> Salibi.K, op.cit, p. 116.

Chevalier.D, op.cit, p. 360.

<sup>51</sup> Owen.R, op.cit, p. 154.

<sup>52</sup> Zamir.M, *The Formation of Modern Lebanon* (London Dover, N.H: Croom Helm, 1985) p. 14.

<sup>53</sup> Gates. C.L, op.cit, p. 14.

<sup>54</sup> Issawi. C, op.cit, p. 71.

only a moderate amount of these foreign investments were channeled into agriculture and the silk industry.<sup>55</sup> This can be explained by the French divestments from the silk industry in 1870s and 80s. French ownership of silk-reeling factories declined from 56 per cent in 1852 to less than 5 per cent in 1885. This French withdrawal from the industry coincided with higher local investments in silk production.<sup>56</sup>

Nevertheless, the French interest in Beirut was shown in other investments. There was the French *Compagnie Ottomane de la route Beyrouth-Damas* and other infrastructure companies like *Compagnie du gaz de Beyrouth* and the water company *Eaux de Beyrouth*.<sup>57</sup> Other French investments were channeled into fields dominated by utilities. The French divestments from the silk-reeling industry were due to the lack of interest. Cheaper products became available somewhere else, and thus investing in Lebanon's silk industry became economically unattractive and less profitable. Their following investments in utilities showed their interest in developing the role of Beirut as a regional hub. The Beirut-Damascus road is a good example of the French intention to improve trade with the region through Beirut.

### **1.3.3 The establishment of the French mandate**

The Maronites strove during their history in the area of Mount Lebanon to achieve their autonomy and independence from the Muslim authority. To claim that the Maronites always longed to have their own separate entity within a defined territory is no exaggeration. France, their patron for centuries, was the European power to be entrusted with fulfilling this long-held aspiration. This dream came close to reality in World War I, particularly after the French troops seized the territories of Syria and Mount Lebanon. The later San Remo conference in 1920 gave France the mandate over Lebanon and Syria. On 1<sup>st</sup> September 1920, General Gouraund, the French High Commissioner for Syria and Lebanon declared the establishment of "Grand Liban" to the delight of the Christian Maronites of Lebanon. The new entity comprised, in addition to Mount Lebanon, the annexed areas of the Bekaa Valley, Jabal Amil (in the south) and the whole coastal line stretching from the north of Tripoli to the borders of Palestine, which was placed under a British mandate. The towns of Beirut, Sidon and Tyre were

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<sup>55</sup> Gates. C.L, op.cit. p. 17.

<sup>56</sup> Ibid. p. 14.

<sup>57</sup> Ibid. p. 15.

included. It was claimed that these territories had been detached from the Lebanon Principedom (*Imarah*) under the *mutassarifate* system that was established after the civil war of 1860. Salibi considered the French declaration of the establishment of Greater Lebanon as representing “a fulfilment for the Lebanese nationalist aspirations”.<sup>58</sup> However, it is worth mentioning that this was not a Lebanese aspiration, if the term Lebanese was to include the inhabitants of the newly annexed regions. It was rather a Maronite wish. The Muslims had their own aspirations hoping to join Syria in a united Arab state, hence their opposition to the declaration.

The creation of the Lebanese State, however, was viewed by many historians as not being a mere fulfilment of the French pledges to the Maronites but more as a French interest. Meir Zamir considered that “the establishment of Greater Lebanon must therefore be examined in the wider aspect of French policy in the Levant during and immediately after the war”.<sup>59</sup> He asserted that the French “civilising mission” had the clear political goal of strengthening France’s position in an area in which its interests go back for centuries, and where its missionaries were first to lay the foundations for its colonial ambitions.<sup>60</sup> Even the stretching of Lebanon’s boundaries was more of a French aim than a Lebanese, as they realised the importance of Beirut as an outlet for Mount Lebanon. The Lebanese historian, Hassan Halak, quoted a political memorandum sent from the French administration of the League of the Nations to the political and commercial administration in 13 August 1920, in which the French stated that Lebanon required the boundaries that were recognised by France in 1860. It also said that not joining Tripoli [north Lebanon] and Beirut [the capital] to Lebanon meant that this country was doomed to die. It stated overtly that “Lebanon must stay the base for French influence in the Levant, and as much as it could be strong and viable France could strengthen its position in Syria”.<sup>61</sup>

The French economic interest in Lebanon was also significant. The French capital that was invested in Syria and Mount Lebanon before World War I was estimated at more than FF200 million. Indeed, France had controlled almost all aspects of the economy in both countries concerned at the turn of the century. These included: The Ottoman Public

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<sup>58</sup>Salibi, K., op.cit, p. 119.

<sup>59</sup>Zamir, M., op.cit, p. 38.

<sup>60</sup>Ibid. p. 39.

<sup>61</sup>Halak, H., “*Tarikh lubnan al-mu’assir 1913-1952*”, *The Contemporary History of Lebanon 1913-1952*, (Beirut: Dar a-Nahdah al-‘arabiah, 1994) p.100.



Debt Committee (France had more than 63 per cent of Ottoman Public Debt), Damascus-Hamah Railway Company; Beirut Port Company, Electricity and Water Companies, Tobacco Company, in addition to the French banks, mainly the French company of *Banque de Syria et du Grand Liban*, Real Estate Bank of Syria, Leon Credit Bank, and the Maritime Transportation Company. All these companies were holding the reins of the economy in the two countries, and were overtly transferred into a monopoly in the interest of the French capital.<sup>62</sup> These investments could explain the French anxiety to protect interests in the region. Indeed, these interests incited the French to prefer maintaining the *status quo* before the war (i.e. supporting the ailing Ottoman Empire's authority) to avoid further European competition in the region. Indeed, this had happened after the defeat of the Ottomans as the French and the British sat to divide the Levant between each other. The meeting between Clemenceau and Lloyd George, in March 1919, revealed explicitly the difference in the interests of the two powers. The French insisted on having all of Syria while the British considered that the French should have only Lebanon with a certain limit in the north to leave a sea outlet for the British and the Arabs. Lloyd George was not happy either with having to grant the French control over the northern railway that stretched to Turkey.<sup>63</sup> Basically, the British were trying to minimise the French influence in the Levant while French interests were too dear to be given up.

The French contributed greatly during their mandate over Lebanon to the shaping of the Lebanese state. In 1926 a new constitution was founded which was almost a copy of the French constitution. However, this period witnessed strict French control over the country. The French language became an official language, and the Lebanese flag was a French flag with a Cedar tree in the middle. Muslim opposition to the French mandate and to the concept of a Lebanese entity was suppressed. Hence, Muslim leaders realised that they needed to accommodate themselves to the new situation. For this positive development, the French administration rewarded them by appointing a Muslim to the post of the speaker of the parliament, Sheikh Mohammed al-Jisr. However, Hasaan Halak told that when Al-Jisr was nominated to the presidency by Muslims and a notable number of Christians, the French rejected him strongly. They then suspended the

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<sup>62</sup>Dahir, M, *Tarikh lubnan al-ijtima'i 1914-1926 (The Social History of Lebanon)* (1974) p.111.  
Zamir, Op.cit, p. 39.

Taqi a-Din, S, *al-Tatawwur al-tarikhi li-mushkila al-lubnaniyya 1920-1970 (The Historical Development of the Lebanese Problem 1920-1970)* (1977) p. 39.

constitution and appointed a Christian president. Halak argued that the French declared overtly that the president should be a Maronite Christian as they thought the only way to guarantee their influential role in Lebanon was through keeping the power in the hands of the most loyal subjects, the Maronites. The appointment of Charlie Dabbass, who was not Maronite but was Christian, to the presidency was the result of the tough competition between the two prominent Maronite candidates, Emile Ideh and Bashara al-Khury. However, this rigid French opposition to the Muslim candidate shows their anxiety over their own interests and not those of the Maronites as might seem to have been the case. The French realised that if a Muslim became a president, even a pro-France one, Pan-Arabism zeal would be motivated in both Lebanon and Syria, and incite again a struggle for the Arab unity. This would by no means match the French interests in the country, argued Halak.<sup>64</sup>

#### **1.3.4 French economic interests in Lebanon during mandate period**

Since France proved to be purely motivated by self-interest in establishing Greater Lebanon, it was to be expected that the French would utilise the economic sectors of the country to their own pure benefit. They tried to improve the sectors that they were benefiting from, while neglecting the productive sectors that were seen as beneficial to the national economy of Lebanon. Beirut's port witnessed vast improvements, which strengthened its position as the main entrepot for import, export and transit services. Meanwhile, the French were criticised for neglecting the port of Tripoli in the north, on the basis of it being located in an Arabist stronghold.<sup>65</sup> The French mandate period marked further centralisation of economic activities in Beirut. French, and non-French, capital flowed mainly into banks, insurance companies, transportation and public services. Meanwhile, domestic industry faced explicit French disapproval of its development.<sup>66</sup> France was the main exporter to the Lebanese market, thus, the maintenance of productive sectors' backwardness was crucial for preserving French hegemony over the market. In contrast, the French mandate supported services.

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<sup>63</sup>Halak.H, op.cit. p. 67.

<sup>64</sup>Ibid. p. 137.

<sup>65</sup>Taqi a-Din. S, op.cit, p. 40.

<sup>66</sup> Ibid. p. 42.

Tourism, for instance, was encouraged by lifting taxes imposed previously on hotels, entertainment places and houses and villas for rent.<sup>67</sup>

French capital received comparative advantages, as opposed to other foreign or local capitals. The establishment of French authority in Lebanon meant having the French High Commissioner in charge of policy making. This, according to Gates, brought institutional changes to the benefit of French businesses and allowed French bureaucrats to promote French firms against other European or local businesses. French companies by then were able to prevent any other foreign competitors from venturing in the Lebanese economy.<sup>68</sup> French investments in Lebanon during the mandate period reached FF 822.10 m. These were concentrated mainly in the banking sector (84.9 per cent) while the rest was distributed between utilities, ports, railways and tourism.<sup>69</sup>

Foreign trade was also shifted to France's benefit during the mandate period. France replaced Britain as the main exporter to Lebanon. Meanwhile, imports from the neighbouring region remained relatively stable at 25 per cent of total imports. However, the decline in the silk industry changed the composition of Lebanese exports towards primary and manufactured commodities. Neighbouring markets received more Lebanese exports in the mandate period compared to the pre-war time. This can be explained by the change in trade components in which silk used to be the main exported product to Europe before the first war. In 1938, Lebanon exports to Palestine exceeded its exports to France. Palestine became the main market for Lebanon's products which comprised agriproducts, foodstuffs, textiles, cement, shoes and leather. Meanwhile, Lebanon's imports coming mainly from France included foodstuffs, textiles, garments, fuels, capital and producer goods and other.<sup>70</sup> France's supremacy as the main exporter to Lebanon was to remain unchallenged until the end of the mandate.

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<sup>67</sup> Taqi a-Din. S, op.cit, p. 47.

<sup>68</sup> Gates. C. L, op.cit, p. 19.

<sup>69</sup> Ibid.

<sup>70</sup> Ibid. p. 29.

**Table 1.1 French investments in Lebanon during the mandate**

Category and firms	FF million	Share (%)
1- Banks	698.30	84.9
Banque de Syrie et du Liban	300.00	
Crédit foncier de Syrie	6.00	
Crédit foncier d'Algérie et Tunisie	125.00	
Compagnie Algérienne	267.30	
2- Utilities	77.00	9.4
Electricite de Beyrouth	75.00	
Societe d'électricite la Kadicha	2.00	
3- Ports and Entrepots	20.50	2.5
Compagnie du port, de quais, et d'entrepôts de Beyrouth	16.00	
Compagnie générale du Levant	4.50	
4- Railroads	15.00	1.8
Compagnie française du chemin de fer DHP	15.00	
5- Miscellaneous	11.30	1.4
Radio-Orient	3.30	
Grands hôtels du Levant	8.00	
Total	822.10	100

*Source: Gates. C. L (1998), p. 19*

### 1.3.5 End of the French mandate

Complaints against the French mandate started to rise in Lebanon as people saw in it an aspect of colonisation instead of mandatory authority (that was assumed to be qualifying the native population to manage their country). A growing co-operation developed between the Sunni Muslims and a significant proportion of the Maronites who aspired to independence from France. The latter tried to secure its interests in Lebanon by the treaty of 1936, similar to that agreed with Syria. However, this attempt failed in both countries. During World War II, Lebanon came under the control of Vichy France. Concurrently, the government of Free-France - established in exile in Britain - promised the Lebanese independence once the war was ended and its authority restored. When the Free-France troops occupied Lebanon, thanks to the British, they had to fulfil their pledges of independence guaranteed by Britain. Indeed, the British were the predominant power in the Levant after the war as France was exhausted - a fact realised by a large proportion of the Lebanese. The new bourgeoisie, a prominent member of which was Bashara al-Khuri (first president of independent Lebanon later) and his Constitutional Union Party, found that their connections with the British would

be the sole way to get rid of a French mandate that was no longer serving their interests.<sup>71</sup> Under British pressure, France had to recognise the independence of Lebanon on 22 October 1943.

### **1.3.6 French interests after independence**

The recognition of Lebanon's independence, which the French unwillingly accepted in a period of weakness, did not mean in any way that they were ready to abandon all their interests in the country easily. French interests in Lebanon were as dear to France as those of Syria. Thus, France tried hard to conclude treaties, through which it could safeguard its cultural, economic and strategic interests. The governments of the two newly independent states rejected such treaties vehemently. However, the French were willing to use all means available to force a compromise. Among these means was the presence of the foreign troops (French and British) and the *troupes spéciales* (composed of local soldiers but still under French command). Lebanon and Syria raised the matter at the UN Security Council, where a prolonged debate took place. In an overt attempt to sideline the UN, the French representative, Foreign Minister George Bidault, declared that the French and the British would solve the problem together, under the French-Anglo Agreement of December 13, 1945. Meanwhile, the British representative Sir Alexander Cadogan expressed his government's desire to withdraw the British troops from the Levant "at the earliest possible moment".<sup>72</sup> This showed clearly the disparity between Britain and France over the Levant problem. The resignation of General De Gaulle from the French presidency eased the tension between France and Britain on the one hand, and France and Levantine states on the other. De Gaulle had wanted to guarantee a special position for France in the Levant and was at the same time very suspicious of the British intentions to replace France's influence in the region. The new government held military talks on the withdrawal with the British in Paris, March 1<sup>st</sup> 1946. A Lebanese delegation participated, and a schedule was agreed upon. The evacuation was completed on April 17 from Syria, and on December 31, 1946 from Lebanon.<sup>73</sup>

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<sup>71</sup>Taqi a-Din. S, op.cit. p. 57.

<sup>72</sup>Abu Salih. A. S, History of the foreign policy of Lebanon, 1943-1958 (PhD thesis: 1971) pp. 50-66.

<sup>73</sup>Ibid, pp.63-66.

The collapse of France's political and military hegemony over Lebanon after independence was accompanied by a deterioration in some aspects of its economic domination. France lost its position as the major exporter to Lebanon. The mandate authorities had played a major role in preventing non-French products from competing with the French ones, as was mentioned earlier. After the war, US exports to Lebanon and Syria jumped straight to the top of the list, without any significant competition, while Britain came second. France's share meanwhile deteriorated severely. This plunge in the French share was due to many major changes: the absence of the French mandate authority, which freed the market from severe restrictions; the resentment among the native population of the negative French position regarding Lebanese aspiration for independence; and the crucial weakness of France's economy after the war.<sup>74</sup>

The US's swift invasion of the markets, in both Lebanon and Syria, was due to the strength of the American economy, that had not been affected by the war in the other parts of the world. The US economy was growing rapidly while the economies of the other powers were exhausted by the war expenses. Nevertheless, Britain's exports' growth was due to the eminence Britain gained as a consequence of its support for those who had demanded independence.<sup>75</sup>

The deterioration in France's trade with Lebanon after independence, however, should in no way be interpreted as evidence that the French economic hegemony over Lebanon had collapsed forever. Indeed, although Lebanon's economy was contained in the Sterling zone for a few years, France managed to draw it back to the Franc zone through the Catroux Accord of 1944, which gave France great control over the country's reserves of foreign currency needed by merchants to finance their imports. Moreover, France held the reins of monetary policy through the *Banque de Syrie et du Grand Liban* which was still under French administration. Meanwhile, the French influenced many other sectors through the French companies whom the new independent government had agreed to honour with their previous concessions, particularly in public utilities. The Franco-Lebanese Monetary Agreement of 1948 institutionalised the French predominance, as it regulated Lebanon's place in the Franc zone and provided [only] partial access to the countries' foreign currency reserves held in Paris until

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<sup>74</sup>Dahir. M, op.cit, pp. 58-60.

<sup>75</sup>Ibid.

1953.<sup>76</sup> This accord was seen by the Lebanese administration as a “cornerstone of a policy aimed at creating a strong, fully convertible currency in which international markets had confidence”.<sup>77</sup> Under this agreement, the French central bank guaranteed the convertibility of 67 per cent of Lebanon’s French Franc balances at a fixed pound Sterling/French Franc exchange rate until 1958, while Lebanon was freed from the *de jure* monetary dependence on France.<sup>78</sup> As a result of this accord, a third of the French-held Lebanese Franc balances were guaranteed and they lost 45 per cent of their value after the devaluation of the French currency the day after the agreement went into effect. Moreover, Lebanon agreed to buy French-abandoned property in Lebanon for LL 20 m and also to respect the French concessions until their expiry dates.<sup>79</sup> The French also established a number of organisations that had the aim of maintaining business interests in the country. One of those was the semi-official trading company *Société d’études et de réalisations industrielles, agricoles et commerciales* (SORIAC). This played a major role in fighting other foreign firms’ interests in Lebanon and trying to win contracts for French firms. Eventually, the Lebanese government was forced to take action against SORIAC to curb its corrupted ways of conducting business.<sup>80</sup>

#### 1.4 Conclusion

European relations with Lebanon up until its independence were obviously dominated by the French. Britain challenged the French at some points in time, trying to gain a foothold in the Ottoman controlled territory. The Russians and the Austrians also tried this. However, those attempts were prominent when France’s influence in the Ottoman Empire was weakened. French interests in Mount Lebanon were similar to the overall European interests in the Middle East and North Africa: sources of raw material and potential markets. However, the difference between the case of Lebanon and the rest of the region is the cultural connection that France launched with the Catholic Maronites of Mount Lebanon since the 12<sup>th</sup> century. However, France’s interests can by no means be considered as motivated by the mere moral obligation towards their co-religionists. The French had economic interests in the territory resembling to a great extent their

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<sup>76</sup>Owen, R, The Economic History of Lebanon 1943-1974: Its Salient Features. In Barakat.H (ed) Towards a Viable Lebanon (London: Croom helm, 1988) p. 30.

<sup>77</sup>Gates. C.L, op.cit, p. 97.

<sup>78</sup>Ibid.

<sup>79</sup>Ibid.

<sup>80</sup>Ibid. p. 93.

colonial interests in North Africa. Hence, Zamir emphasised that the French missionaries were the first to lay the foundations for their colonial ambitions.<sup>81</sup> They supported agriculture in Mount Lebanon by encouraging silk production, which was needed to feed the silk factories of Lyon and Marseilles. French businesses got engaged in the silk-reeling industry in the 19<sup>th</sup> century, the produce being exported to France to supply the textile industry. However, they were the first to withdraw once competitive industrial silk started coming from Far Asia. That move harmed the economy of Mount Lebanon, which by then was dependent on the French market for its single crop produce. The French 'moral obligation' towards the Maronites did not prevent them from rendering their silk agricultural and industrial production obsolete. However, the French developed transportation by enlarging the port of Beirut and improving roads and other utilities. This was for the sake of their foreign trade. French banks that operated in Beirut were mainly there to provide commercial loans for foreign trade with France. During the mandate, as was mentioned earlier, France developed the commercial position of Beirut ignoring the productive sectors of the economy. This says a lot about the importance of Lebanon as a market for foreign trade, and an entrepôt for exports into the region. The economy of Lebanon was shaped to be dependent on France and to create opportunities confined to French businesses only. Inevitably, this helped in making the French businesses more aware of, and knowledgeable about, the Lebanese market, when compared to other foreign businesses. The thesis will test whether this, despite the French departure from Lebanon, and the decline in France's influence, is still an advantage for French companies conducting business in Lebanon today.

Concerning the question of foreign direct investment, we can argue that the modern history of Lebanon had some periods during which foreign investments flowed into it. This means that it was once an attractive destination for FDI. Obviously, the interest in investing in the country was limited by the opportunities arising at the time. The silk industry proved to be the niche for foreign direct investments in the 19<sup>th</sup> century. The significant flow of French capital and expertise into this sector in Mount Lebanon is a valid example. Apart from the economic growth instigated by this industry in Lebanon, the country became a major source of silk for the textile industry in France. This foreign capital would not have been directed to Lebanon if opportunities for business had not

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<sup>81</sup> Zamir. M, op.cit, p. 39.



been attractive. The raw material for silk industry was available and ready to develop while local labour was abundant. Meanwhile, foreign investors brought capital and expertise. The result was, on the one hand, economic growth for the region materialised in higher incomes from agriculture that provided the raw materials and in employment opportunities, while on the other, it provided intermediate material for European industries. However, this industry deteriorated when it became less attractive to produce in Lebanon. Investments in the silk industry in Mount Lebanon can be compared to contemporary foreign investments in oil industries. Foreign companies invest huge capital in oil-producing countries. However, had a substantial alternative source of energy been discovered, massive waves of divestments would be inevitable.

On the other hand, other business sectors had a fair chance to flourish, like the financial and non-financial services in Beirut late in the 19<sup>th</sup> century. The location of Beirut on the Mediterranean and its proximity to the silk-producing mountains gave the city certain advantages. As it was mentioned earlier, at some points in time, European merchants wanted to operate from Beirut as they felt safe being close to the mountains to which they could flee in case of trouble. This can be seen as another location-advantage that played a pull-factor role at that time. The essence of this argument is firstly, that Lebanon has been attractive for European businesses and direct investments at some periods of time, when certain pull-factors were available in the country. If similar or relevant pull-factors occurred in Lebanon at other periods of time, the country should be considered an attractive destination for European and foreign investments. Secondly, Europe has a history of business activity with, and in Lebanon, including FDI. This history, as the thesis will demonstrate, has played some role in determining the present willingness, and capability, of European investors to consider Lebanon as an FDI destination. The role of France is particularly significant in this regard.

## **Chapter Two: The Development of Economic Relations between European Countries and Lebanon since the Establishment of the EC**

### **2.1 Introduction**

The aim of this section is to assess the impact of the creation and development of the EU on European economic relations with Lebanon. The previous chapter highlighted the European interests in Lebanon within the context of their interests in the Middle East in the 19<sup>th</sup> and early 20<sup>th</sup> century. This chapter will highlight the relations between the EU and Lebanon within the context of the former's relations with the Arab Mediterranean countries. In order to achieve this, I shall trace the development of relations between the European Community and Lebanon and within the contemporary context of Euro-Mediterranean Partnership. That will include a survey of the EU policies towards Lebanon and an analysis of trade between the EU member states and Lebanon. By the end of this section, I shall establish whether these relations ever involved the flow of FDI from the EU into Lebanon. I shall also investigate whether EU policy towards Lebanon is encouraging for EU private businesses or not.

### **2.2 The foundation of the EC**

The European Economic Community (EEC) was officially established on 1 January 1958 by the Treaty of Rome. The six founding countries included Belgium, the Federal Republic of Germany, France, Italy, Luxembourg and the Netherlands. Simultaneously, another community, the European Atomic Energy Community (Euratom) was established.<sup>82</sup> Six years before, on 18 April 1951, the same countries had signed the treaty establishing the European Coal and Steel Community (ECSC), which came into force on 23 July 1952, and which is considered to be the first stone in the building of the European Community. Its idea was introduced on 9 May 1950 by Robert Schuman, the then French Foreign Minister, who put forward a plan for France and Germany to "pool all their coal and steel production under a joint High Authority, within an organisation open to any other country in Europe".<sup>83</sup>

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<sup>82</sup> Borchardt, K, European Integration, the Origins and Growth of the European Union, (European Documentation. Periodical 1995) p. 9.

<sup>83</sup> Ibid.

However, the appeals for European unity go back to the 1920s. One of the first attempts took place in the aftermath of the First World War, when in 1923 the Austrian founder-leader of the Pan-European movement, Count Coudenhove Kalergi, called for the creation of the United States of Europe. Other attempts followed but were doomed to be unsuccessful due to the nationalistic and imperialistic ideologies which dominated Europe at that time. Only after the devastation produced by World War II was the idea of European unity accepted. The total collapse of Europe accompanied by the “political and economic disintegration of outdated national structures set the stage for a completely fresh start and called for a far more radical approach to the reordering of Europe”.<sup>84</sup> The Europeans realised that they had turned into weak nations and had lost their prominence in the international arena. Their political and economic supremacy had been eclipsed by two new ones, the USA and USSR. This realisation and the understanding that only unity could put an end to “Europe’s woeful history of conflict, bloodshed, suffering and destruction”<sup>85</sup> were crucial factors prompting the idea of European unity.

Without denying the tremendous role played by the woeful situation of Europe after the war in pushing towards unity, it can be argued that economic factors were the real catalyst for the success of the European Community. The fact that the unification procedure did not interfere in the members’ politics and was purely economic contributed to this success. The Treaty of Rome stated clearly that the Community, by the establishment of a common market and an economic and monetary union, should have the task of promoting a “harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a standard of living and quality of life, and economic and social cohesion and solidarity among member states”.<sup>86</sup> This pattern was maintained until 1970, when the basis for political co-operation between member states was established under the European Political Co-operation agreement (EPC), and improved by the Single European Act in 1987. However, this did not go beyond consultation between foreign ministers and constant contact between officials. The aim was to improve communication between the member states over all major

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<sup>84</sup> Borchardt. K (1995), p. 5.

<sup>85</sup> Ibid. p:23.

<sup>86</sup> Treaty Establishing the European Community as amended by subsequent treaties. Rome, 25 March, 1957.

foreign policy issues. In Maastricht, in 1992, the Heads of State and Government signed the Treaty of European Union and agreed “to pursue the gradual development of a common foreign and security policy”.<sup>87</sup>

Thus, Since its foundation, the European Community’s main objective was to achieve economic integration between member states. As Haifaa Jawad pointed out, until the 1970s, the Community’s attention was directed inwards rather than outwards. This attention focused mainly on the removal of trade barriers between the member states, building up the Common Agricultural Policy and achieving ever-improving standards of living for its members.<sup>88</sup>

### **2.3 The European economic approach towards southern-Mediterranean countries**

The European Community’s economic approach to the Arab-Mediterranean countries was not shaped into an organised economic policy until 1972. Before that, relations between the two sides were random, unsystematic and on a case-by-case basis. Lebanon was the first Arab-Mediterranean country to sign a non-preferential trade agreement with the EEC in 1965. Special Association Agreements between the EEC and both Morocco and Tunisia were concluded in 1969. Lebanon and Egypt signed agreements on Preferential Trade in 1972. Enzo Grilli stated that the agreement with Lebanon never entered into force, although he was unable to provide the reasons.<sup>89</sup> These were association agreements concluded under Article 238 of the Treaty of Rome, which entitled the Community to “conclude with one or more states or international organisations agreements establishing an association involving reciprocal rights and obligations, common action and special procedures”.<sup>90</sup>

The agreements between the EC and the Mediterranean non-member states were considered justifiable as many of these countries had strong historical and cultural ties with most of the member states. France had strong connections with the Maghreb countries (Morocco, Tunisia and Algeria), in addition to the previously mandated

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<sup>87</sup> Borchardt, K, op.cit. p. 60.

<sup>88</sup> Jawad, H, *Euro-Arab relations, a study in collective diplomacy*. (Reading, Ithaca Press: 1992) p. vii.

<sup>89</sup> Grilli, E. R, *The European Community and the developing countries* (Cambridge University Press: 1993) p.182.

Mashreq countries of Lebanon and Syria. Italy had substantial relations with its previous colony, Libya, and with Malta and Tunisia. Relations between Germany and Turkey were not to be neglected. Indeed, the factors steering the EC approach towards the southern Mediterranean region have stirred a considerable debate as to whether European interests in the region are political, strategic, or purely economic. Ghassan Salamé perceived European interests in the region as an issue of security “for which the catchword has changed over the years from oil deliveries to terrorism and now to Islamism”.<sup>91</sup> However, it can be argued that the motives for an EC approach towards the region are interrelated. If the European emphasis was on security issues, it has to be said that economic instability in the region can affect the security of Europe. Stability in the region of the Mediterranean (or the Middle East for a wider perspective) is hindered by many obstacles, according to a list drawn by Gerd Nonneman.<sup>92</sup> These were a combination of political, strategic and economic obstructions. Salamé himself recognised the European economic interests in the region when stating that such interests, combined with their reliance on the Middle Eastern oil and gas exports, and public opinion concerns do not allow passive behaviour by the EC towards the area.<sup>93</sup> As far as trade is concerned, this region still represents an important outlet for the EC exports.<sup>94</sup> Another concern that should be highlighted is the potential for an increase in immigration from the region of the Mediterranean (and the Middle East) as a result of economic failure or political upheavals.<sup>95</sup> Therefore, a combination of factors including strong historical links, proximity, security, potential for markets and fear of excessive immigration contributes to Europe’s interest in the region of the Mediterranean. Although the US and the Soviet Union had stronger influence in diplomatic or militarily crises in the region, Ellen Laipson noted that, judged by other terms, “Europe has, and is

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<sup>90</sup> Text of the Treaty establishing the European Community as amended by subsequent treaties, Rome, 25 March, 1957. Part six, Article 238.

<sup>91</sup> To emphasise the impact of proximity on security issues, he recalled the incident of two “missing-target” Libyan missiles falling on an Italian island in 1986.

Salamé, G, Torn Between the Atlantic and the Mediterranean: Europe and the Middle East in the Post-Cold War Era. *Middle East Journal* (48) no.2. Spring 1994, p. 11.

<sup>92</sup> Nonneman, G, Key Obstacles to Stability in the Middle East. In Nonneman, G, *The Middle East and Europe* (ed) second edition (London: Federal Trust for Education and research, 1993) p. 29.

<sup>93</sup> Salamé, G, op.cit, p.2.

<sup>94</sup> Grilli, E.R, op.cit, p. 180.

<sup>95</sup> Miller, G, An Integrated Communities Approach. In Nonneman, G, *The Middle East and Europe*. Op.cit, p. 3.

likely to continue to have, a more sustained and durable political, economic and cultural presence in the region".<sup>96</sup>

However, despite the fact that the Mediterranean basin is a strategic and vital region for Europe, the EC did not manage to develop a coherent policy in its approach to this particular area. The EC's relations with the Mediterranean countries were confined to bilateral agreements with individual countries, mainly concerned with trade without any signs of co-operation. This approach, in many cases, could be seen as contradictory to the Treaty of Rome, which emphasised that the purpose of association with the overseas countries and territories that have special relations with EC Member states is to promote the economic and social development in these countries, establish close economic relations with them, further the interests and prosperity of the inhabitants of these countries to lead them to the economic, social and cultural development to which they aspire.<sup>97</sup> The EC's approach hardly included any of these objectives.

### **2.3.1 The Global Mediterranean Policy**

In 1972, a new approach towards the Mediterranean countries was adopted under the new Global Mediterranean Policy (GMP). At the Paris summit in October 1972, the Heads of States and Governments declared that the Community "attached essential importance to the fulfilment of its obligations towards the countries of the Mediterranean basin with which agreements had been or will be concluded, agreements which should be the subject of a global and balanced approach".<sup>98</sup>

The new Global Mediterranean Policy seems to have had several motives. A mixture of political and economic developments urged the EC to re-think its Mediterranean policy. However, literature does not agree on the reasons for the establishment of the GMP. Some authors, like Nadia Mustafa, argued that with the GMP it became obvious that the EC was trying to strengthen its political presence in the region. This aim was significantly different from the pre-GMP aims, which were purely concerned with

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<sup>96</sup> Laipson, E, Europe's Role in the Middle East: Enduring Ties, Emerging Opportunities. *Middle East Journal*. (44) no. 1. Winter 1990. p. 7.

<sup>97</sup> Treaty of Rome, Part four. Article 131.

<sup>98</sup> Grilli, E. R, op.cit, p.185.

economics, particularly trade.<sup>99</sup> Jawad agreed on the political considerations saying that the Europeans were eager to reduce the influence of the superpowers (US, USSR) in the region, an influence which had come to fill the vacuum left after the decline of European influence following the Suez War.<sup>100</sup> Strategically, the Mediterranean countries were keen to see the EC challenging the other powers in their region in a way to ease the absolute control of those powers, she stated. However, Jawad looked at the economic-strategic considerations as well, highlighting the fact that Mediterranean countries were either the sources or the outlets of their oil supply coming from the Middle East or North Africa. Thus, the EC wanted to secure these sources. Although she pointed out that the 1973 oil crisis increased the importance of a new Mediterranean policy, this development should not be seen as particularly influential in the establishment of the GMP policy as it was launched before the crisis appeared. Nevertheless, Jawad considered that the emerging economic power of the EC after achieving the Customs Union and the Agricultural Common Market, and the scheduled joining of the UK, Ireland and Denmark in 1973, created the best time for a more "ambitious co-operation policy". External pressure on the EC coming through the international trade negotiations (Tokyo Round) held under the GATT, which opposed, with the US, the trade preferences in the Mediterranean, was proposed by Jawad as another reason for the GMP.

Enzo Grilli added to these reasons the widespread dissatisfaction among the EC member states at the patchwork of agreements reached in the 1960s, most of which were due to be renegotiated soon. On the other hand, he pointed out that the oil producing countries were becoming assertive in their claims over the control of their natural resources, and that the sea routes of this vital commodity seemed to be threatened by the Soviet naval presence in the Mediterranean. The good economic conditions of the EC, characterised by expansion in its economies' output and full employment, according to Grilli, represented a favourable time for the EC to "pay greater and more systematic attention to the Mediterranean region".<sup>101</sup>

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<sup>99</sup>Mustafa. N *Qroupa wal watan al-'arabi* (Europe and the Arab World), (Beirut: markaz dirassat al-wihdah al-'arabiah, 1986) p.212.

<sup>100</sup>Jawad. H, op.cit, pp. 28-31.

<sup>101</sup> Grilli. E. R, op.cit, p:186.

### 2.3.2 Agreements concluded within the GMP

Upon the approval of the Council of Ministers in November 1972, the European Commission was instructed to commence negotiations of new agreements with the Mediterranean countries from June 1973. Grilli pointed out that the “articulation of a *global approach* towards the area was being based for the first time on clear and explicit premises”. He stated that these premises were proximity, similarity of climatic and ecological conditions - “and thus of agricultural productions”- with southern Europe, reciprocal interests in the area of energy and labour supply, and the role of a bridge between the Community and Africa played by the Maghreb and Mashreq countries.<sup>102</sup>

Negotiations with the Maghreb countries started in 1973. However, the co-operation agreements with those countries were not concluded before 1976. Algeria signed an agreement with the EC for the first time as an independent state, while Tunisia and Morocco had had Special Association Agreements since 1969. Negotiations with the Mashreq countries did not start until 1976 despite the demands of those countries since 1973. Co-operation Agreements with Egypt, Jordan, Lebanon and Syria were signed in 1977. The Agreements with Syria and Jordan were their first with the EC.<sup>103</sup>

**Table 2.1 Agreements signed with non-member Mediterranean countries pre-Euro-Med**

Country	Non-preferential trade agreement	Preferential trade agreements	Special Association Agreement	Co-operation Agreement
Morocco			1969	1976
Algeria				1976
Tunisia			1969	1976
Libya				No agreements
Egypt		1972		1977
Israel				1975
Jordan				1977
Syria				1977
Lebanon	1965	1972		1977
Turkey				
Cyprus			1972	

*Source: Compiled by the author from various sources.*

<sup>102</sup> Grilli. E. R, op.cit, p:186.

<sup>103</sup> Enzo R Grilli, op.cit, pp. 182.  
Jawad.H, op.cit, pp. 31.



The negotiations for the new agreements were tough and encountered many difficulties, according to Jawad. The disagreement among the member states concerning the agricultural side of the GMP was one of the main obstacles to overcome. Consumer countries that did not produce agricultural products competitive to Mediterranean products, like Britain, favoured agreements which would guarantee cheaper food imports. Meanwhile, producer countries, like France and Italy, feared the potential competition from non-member Mediterranean countries' products. They considered the agreements a real threat to their own agricultural production.<sup>104</sup> However, such reservations did not reflect the real positions of these two countries towards the Mediterranean policy. Indeed, France was the member state that pushed forward the plan of the new Mediterranean policy at the Paris Summit, while Italy was also keen on moving from the periphery of the EC to be at the centre of a larger integrated community. Their concern was to offset any negative impact of the agreements by imposing restrictions on agricultural imports. Italy was looking for compensation from the EC, which was to come in the form of support to its agricultural sector and opportunities for its labour force in northern European countries.<sup>105</sup> In this sense, the two member states cannot be considered to have been jeopardising the new approach to the Mediterranean in the 1970s but were merely concerned to defend their own interests.

The new Co-operation Agreements followed the same pattern with each southern Mediterranean country. They granted the industrial products of the Mediterranean countries free access to the EC markets. Refined petroleum and certain textiles were excluded, however, to protect the European textile industries. Poor countries, like Egypt, Tunisia and Morocco were affected badly by this decision, as textiles represented their main industrial exports. With regard to agricultural products, the measures adopted in the agreements did not favour non-member countries as tariff concessions were confined to a limited range of products and calendar restrictions were imposed to protect EC production. Jawad considered that it was basically a policy aimed to provide EC markets with non-seasonal agricultural products.<sup>106</sup>

Taking into consideration the GATT rules of international trade, Grilli pointed out that the EC wanted the trade relations with the southern Mediterranean countries to be based

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<sup>104</sup> Jawad, H, *op.cit.*, p. 31.

<sup>105</sup> *Ibid.* p. 22.

<sup>106</sup> *Ibid.* p. 33.

on reciprocity. However, "reverse preferences from the Mediterranean countries to the Community could be graduated in time and extent to reflect the differences in levels of development of the various countries". He emphasised that the objective of the new Mediterranean policy was to extend concessions covering at least 80 per cent of the agricultural products exported by each Mediterranean country to the Community, and thus "establish the basis for the creation of a free-trade area with these countries".<sup>107</sup>

On the financial and technical side, the agreements included financial and technical aid, to help with the development of the Mediterranean countries. The seven Arab countries concerned were destined to receive an amount of ECU 669 million in the period 1978-82 under the first protocols. In the allocation of this money, the poorest countries, like Morocco, Lebanon and Egypt had priority over the others.<sup>108</sup> The subsequent financial protocols (1982-86) saw a total increase in funds of 52 per cent.<sup>109</sup> In a way, one could view this aid as a substitute for the losses of the southern Mediterranean countries caused by the agricultural policy of the EC, and as a means of supporting and pushing towards industrialisation.

The agreements included a section on establishing joint institutions, by which a cooperation council would manage each agreement. Moreover, the European Commission established a permanent representation in each of the signing countries. Agreements with the Maghreb countries contained a separate section that regulated the status of migrant labour from these countries resident in the EC.

## **2.4 Effects of the enlargements of the EC**

The subsequent enlargements of the EC had several side effects on the non-member Mediterranean countries, mainly those who depended heavily on the EC markets for their exports. The first northern enlargement, for instance, affected Morocco by depriving its fruit and vegetable products from free access to the UK markets, which became subject to the EC trade rules. These products lost their competitive position, as well, to the Mediterranean member states that had the preference for marketing their agricultural products (Italy, France).<sup>110</sup> The second enlargement, during which Greece

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<sup>107</sup>Grilli. E. R, op.cit, p. 187.

<sup>108</sup>Jawad. H, op.cit, p. 34.

<sup>109</sup>Ibid.

<sup>110</sup>Grilli. E. R, op.cit, p. 197.

joined the EC in 1981, posed a serious threat to the Maghreb countries. Greece was a major producer of olive oil, and this meant tough competition for Tunisian and Moroccan exports still subjected to entry duties. The third enlargement in 1986, during which Spain and Portugal joined the EC, raised deep concern among non-member Mediterranean countries as these two new members were producers of the same products of most of these countries. The countries mostly affected were again the Maghreb countries, Morocco and Tunisia in particular, and Egypt. Spain's membership meant an increase in the EC's agricultural production of 25 per cent in vegetables, 48 per cent in fruits, and 59 per cent of olive oil. Thus the self-sufficiency of the EC would reach 100 per cent or more.<sup>111</sup> The economies of Morocco and Tunisia were largely structured upon their dependence on the EC markets as outlets for their agricultural products. All of a sudden, they found themselves in an incompetent position providing free and preferential access for their previous competitors, Spain and Portugal.

The third enlargement of the EC also threatened the manufactured products of non-member Mediterranean countries. Spain and Portugal produced similar products to those produced by the Maghreb countries and Egypt. The premier field of competition was the textile and clothing industries as the EC markets were the main consumers of these countries' textile exports. About 80 to 90 per cent of total textile exports of Morocco and Tunisia in the period 1978-80 were destined for the EC markets.<sup>112</sup> Grilli considered Portugal a strong competitor in textile-clothing exports with Egypt and Tunisia.<sup>113</sup>

#### **2.4.1 Attempts to avoid the negative impact of the enlargement**

The negative impact of the enlargement of the EC on the non-member Mediterranean countries led the former's institutions to seek a new strategy to avoid the adverse effects of the European development on the Mediterranean region. The importance of a closer economic co-operation with the non-member Mediterranean countries was expressed by the Commission of the European Communities. The Commission pointed out that as a leading power in the Mediterranean, the EC had a direct concern in the future

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<sup>111</sup>Jawad. H, op.cit, p. 40.

<sup>112</sup>Ibid. p. 41.

<sup>113</sup>Grilli. E. R, op.cit. p. 199.

development of the southern and eastern Mediterranean countries.<sup>114</sup> It emphasised, as well, that the EC's interests and security were at stake. In its *Guidelines for Economic Co-operation*, in 1985, the Commission considered that the obstacles preventing the development of the non-member Mediterranean countries included:

- Fast population growth with economies unable to absorb a 2-3 per cent a year increase in labour force;
- The coverage of an increasingly large proportion of food requirements by imports;
- Trade deficits; particularly with the Community;
- External debt putting a brake on expansion;
- The great fragility of the industrial fabric.<sup>115</sup>

The Commission suggested three main areas of co-operation that should be given priority:

- Support for the Mediterranean countries' food strategies with a view to reducing food dependence;
- The development of detailed, long-term co-operation in fields such as industry, science and technology, trade, and training- through which Community support would be lent to all those engaged in promoting economic growth;
- Support for the Mediterranean countries' efforts to promote regional and multilateral co-operation, including co-operation with Africa.<sup>116</sup>

Another report introduced by the Committee on Development and Co-operation to the Council of the European Communities in 1986, emphasised again the importance of developing economic co-operation with the non-member Mediterranean countries. The report reaffirmed that the objectives of a global Mediterranean policy were

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<sup>114</sup>The Community and the Mediterranean countries: Guidelines for economic co-operation (communication by the Commission to the Council. Commission of the European Communities. 26-9-1985).

<sup>115</sup>*ibid*, p: 2.

<sup>116</sup>The Community and the Mediterranean..., *op.cit.* p. 4.

*“to establish and enrich the degree of economic interdependence to benefit both North and South of the Mediterranean region; to provide in the medium and long term for increased food production leading to self-sufficiency; to protect and promote the interests of the rural, economic and social infrastructure in the less-developed Mediterranean countries”.*<sup>117</sup>

The Committee's report considered the allocation of proper financial resources and their management crucial to the outcome of the EC's Mediterranean policy. It also supported the development of joint ventures in small and medium sized rural industrial projects. The need to ensure mutually acceptable levels of trade, in which the interests of the poorest Mediterranean countries regarding their 'so-called' sensitive products should be protected, should be given particular attention, the report stated. Moreover, it recommended that the EC institutions, IMF and World Bank help to solve debt problems of the countries in the region, in a way to help the poor people to produce their own needs. At the same time, food strategies should be devised to achieve agricultural self-sufficiency; the promotion of private investment in the Mediterranean countries, and improvement of social and cultural policies in the EC aiming at the harmonious integration of migrant workers and their families into European societies was required.<sup>118</sup>

Many of these recommendations were repeated in 1989 in an opinion released by the Economic and Social Committee, which urged the Community to redress the shortcomings of its Mediterranean policy. This was all the more important as the region was becoming the focus of US and Japanese trade, investment, economic aid and above all, technological "colonisation". Moreover, it pointed out the demographic gap between the EC, whose population forecasts anticipated a fall from 320 to 310 million in 2020, and the TMCs (Trans-Mediterranean Countries) whose population was expected to rise from 200 to 500 million. In such case, this "demographic time-bomb" would affect the Community, who in no way would be able to curb the entry of millions of emigrants.<sup>119</sup>

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<sup>117</sup> Renzo Trivelli (Rapporteur), Report drawn on behalf of the Committee on Development and Co-operation, on the communication from the Commission of the European Communities to the Council concerning the Community and the Mediterranean countries: guidelines for economic co-operation. 3.7.1986. p. 6.

<sup>118</sup> Ibid, pp. 7-9.

<sup>119</sup> Opinion on the Mediterranean Policy of the European Community. Economic and Social Committee. 12.7.1989. p. 3.

Thus, the Committee urged the EC to make some changes in its Mediterranean policy including ruling out the protectionist measures against TMC exports, as "they would exacerbate the TMCs' socio-economic problems and lead to a drop in their imports from the Community". The Committee suggested that this should be followed by a joint development strategy between the EC and non-member Mediterranean countries in which competition problems should be tackled, while EC policies (concerning agriculture, industry, energy...etc.) must be revised to achieve balanced geographical and sectoral distribution of production. Moreover, the Committee considered that the disparities between Southern and Northern EC members must be ironed out, in order to give the Southern parts of the EC the role of bridge between the most economically advanced parts of Europe and the developing economies of the Mediterranean countries.<sup>120</sup>

A Mediterranean policy, according to the Committee, should be based on mutual recognition of each country's national and historic identity, and must:

- have a joint perspective which transcends the national interests of the individual member states and TMCs;
- disregard pleas for special treatment from certain TMCs which claim to have closer ties with the Community;
- abandon the current bilateral EC-TMCs relations, as these aggravate the imbalances between Mediterranean nations;
- co-ordinate member states' national TMC co-operation policies within a joint framework, providing Community support (people and resources) for national and regional initiatives, and furthering the transfer of powers in the matter to the Community, which should become the main actor<sup>121</sup>.

The importance of the development and diversification of agricultural products for alleviating dependence on food industries was re-emphasised by the Committee as a goal of the Mediterranean policy. Added to this, was the need for diversification in agricultural exports; economic complementarity between the Community and the TMCs

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<sup>120</sup> Opinion on the Mediterranean Policy of the European Community (12-7-1989), op.cit, pp. 4-6.

<sup>121</sup> Ibid. p. 7.

through co-operation in industrial, services, research and development, training and other sectors; and regional and multilateral co-operation.<sup>122</sup> The latter was given significant attention by the Committee as it considered the regional economic integration of the TMCs “crucial to the integrated development of the Mediterranean basin as a whole”. Special reference was made to the Arab Maghreb Union between Algeria, Libya, Morocco, Mauritania and Tunisia, and the Arab Co-operation Council between Egypt, Iraq, Jordan and North Yemen. These integration attempts were welcomed by the Committee which recommended that the Community support such initiatives.<sup>123</sup>

To sum up, there was a clear disparity between the EC’s Mediterranean actual policies and the recommendations introduced by various committees concerned. A global Mediterranean policy was favoured by all the committees instead of very limited bilateral ties. Moreover, great attention should be given to the development aid, mainly to improve non-member Mediterranean countries’ industrial abilities, and to achieve self-sufficiency in food needs. Through these recommendations, one could draw a map of the region in which the Southern parts of the EC would no more be the periphery of the Community but rather the pivot of interaction between Northern Europe and the Mediterranean basin, a role which would be favoured by southern EC countries as long as their interests were protected. However, most of these recommendations did not seem to have been adopted by the EC and the Mediterranean policy did not witness crucial changes in the 1980s. Apart from the renewal of bilateral agreements, including financial protocols, with most of the Mediterranean countries, nothing else happened.

## **2.5 The Euro-Mediterranean Partnership**

The Euro-Mediterranean Partnership was initialised by the announcement of a New Mediterranean Policy (NMP) in December 1990. After the Cannes summit of June 1995, the initiative developed into a joint conference including the EU members and the 12 non-member Mediterranean countries, which took place in November 1995 in Barcelona.<sup>124</sup> The ‘Barcelona Declaration’, which was adopted unanimously, laid the

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<sup>122</sup> Opinion on the Mediterranean Policy of the European Community (12-7-1989), op.cit, p. 8.

<sup>123</sup> Ibid.

<sup>124</sup> Libya was not included while the Palestinian Authority was represented.

framework for the Euro-Mediterranean partnership and co-operation.<sup>125</sup> Kamal Shehadi noted that this framework had three pillars: political and security issues, social and cultural exchange, and economic development.<sup>126</sup> The economic side of the declaration followed the guidelines prepared by the EU Commission in October 1994 and was endorsed by the European Council in December 1994. These guidelines envisaged the creation of a Euro-Mediterranean Economic Area comprising 600-800 million people and 30-40 countries over the next 10-15 years. It would also be characterised by expanded free trade and foreign investment, substantially increased EU official financial flows and enhanced regional integration among these countries.<sup>127</sup> The outcome of the conference was to establish an economic and financial partnership in the Mediterranean region. This was based on: the progressive establishment of a free trade area; the implementation of appropriate economic co-operation and concerted action in the related areas; and a substantial increase in the EU's financial assistance to its partners.<sup>128</sup>

### **2.5.1 Free-trade area**

The participants in the conference agreed on the establishment of a free-trade area between the EU and its Mediterranean partners. The year 2010 was set as the target date for the full establishment of this area. With due observance of the WTO obligations, most trade was to be covered in the new area. Tariff and non-tariff barriers to trade in manufactured products were to be eliminated progressively according to timetables to be negotiated between partners. Trade in agricultural products was to be liberalised progressively through reciprocal preferential access among the parties but with respect to the GATT negotiations. Trade in services including the right of establishment was to be liberalised gradually with due regard to the GATT agreement.<sup>129</sup>

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<sup>125</sup> Shehadi, K, The Lebanese-European Partnership Agreement as a Pathway to Economic Integration, in Shahin, W & Shehadi, K (Ed) Pathways To Integration: Lebanon and the Euro-Mediterranean Partnership. (Beirut, The Lebanese Centre for Policy Studies: 1997) p. 2.

<sup>126</sup> Ibid.

<sup>127</sup> Riordan, E (and others), The World Economy & Implications for the MENA Region, 1995-2010. Working Paper Series. (Cairo: Economic Research Forum for the Arab Countries, Iran & Turkey, 1995). Working Paper 9519. p. 67.

<sup>128</sup> Commission of the European Communities, Euro-Mediterranean Partnership, Report on the Barcelona Conference 27-28 November 1995. p. 4.



### **2.5.2 Economic co-operation and concerted action**

A wide area for economic co-operation was agreed by the participants. As far as private businesses were concerned, they stressed the importance of creating an environment conducive to investment. This was the result of the participants acknowledgement that economic development must be supported by internal savings, "the basis of investment", and by foreign direct investment. Moreover, enterprises were to be encouraged to enter into agreements with each other. Such co-operation was to be promoted by providing a favourable environment and regulatory framework.

Other areas of co-operation included the development of infrastructure, with particular reference to the need for efficient transport systems, modernised telecommunications, and information technologies.

### **2.5.3 Financial co-operation**

The participants acknowledged the need for a substantial increase in financial assistance in order to guarantee success for the creation of the free-trade area and the Euro-Mediterranean Partnership. In this sense, they welcomed the European Council's decision at Cannes to set aside ECU 4,685 million, in the form of available Community budget funds for the period 1995-99, for financial assistance. Increased EIB loans as well as bilateral financial contributions from member states were to supplement this financial assistance. Moreover, they agreed on the necessity for effective financial co-operation to be managed within the framework of a multi-annual programme, taking into account the special characteristics of each partner. They reaffirmed on the fundamental importance of sound macro-economic management to ensure the success of the partnership.<sup>130</sup>

### **2.5.4 MEDA Programme**

The MEDA Programme is the main financial instrument of the Euro-Mediterranean Partnership, and was instituted at the Barcelona Conference. It has formed the main part of the EU five-year financial assistance package of ECU 4,685 million decided on at the

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<sup>129</sup> Euro-Mediterranean Partnership, Report on the Barcelona Conference, op.cit, p. 4

<sup>130</sup> Ibid.

Cannes Summit in June 1995.<sup>131</sup> The MEDA Programme replaced the twenty-year old Financial Protocols that had previously provided the framework for financial co-operation between the EU and Mediterranean countries. A new Framework Financing Convention was concluded with partners eligible to MEDA. The main feature of the new Convention included:

- The establishment of a national co-ordinator for the beneficiary partner in order to oversee overall programming and implementation.
- A wide field of potential beneficiaries, including private operators and members of civil society.
- The granting of "the most favoured donor" fiscal treatment and the exemption of MEDA financing from taxes and duties.<sup>132</sup>

The funds of the MEDA Programme were to be divided between bilateral and regional co-operation. Approximately 90 per cent of them were to be allocated to bilateral co-operation. However, the two are seen as "complementary to enable the political and economic impact of the MEDA programme to be sustained and the objectives jointly adopted in the Barcelona Declaration more effectively reached".<sup>133</sup>

### **2.5.5 The Euro-Mediterranean Association Agreements**

The signing of Association Agreements between the EU and Mediterranean-neighbouring countries had started before the Barcelona conference. Tunisia and Israel had already signed Association Agreements, while Morocco had initialled one. Agreements with Egypt, Jordan, Lebanon, and the Palestinian Authority were being negotiated or discussed. Cyprus and Malta were already linked to the EU through Association Agreements signed in 1973 and 1971, respectively. Meanwhile, Turkey was preparing to enter a custom union with the EU.<sup>134</sup> These agreements had followed the blueprints of the Euro-Mediterranean Economic Area that was proposed by the Commission in 1994, and upon which the Barcelona Declaration was based.

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<sup>131</sup> Commission of European Communities, *Implementing MEDA 1996-1997 Report*. COM (1998) 524 final. 14.09.98. p. 3.

<sup>132</sup> Ibid. p. 4.

<sup>133</sup> Ibid. p. 7.

<sup>134</sup> The Barcelona Conference and the Euro-Mediterranean Association Agreements, op.cit, p. 3.

The European Commission saw the Association Agreements as the legal instruments for establishing “deeper and wider relations with the Mediterranean partners”.<sup>135</sup> Their provisions built upon the old Co-operation Agreements of the 1970s. These Association Agreements provided for “the institutionalisation of political dialogue, the establishment of a free trade area, economic co-operation, social and cultural and financial co-operation, notably through the MEDA programme”.<sup>136</sup>

**Table 2.2 Association Agreements signed between the EU and Mediterranean countries**

Country	Conclusion of Negotiations	Signature of Agreement	Entry into Force
Morocco	November 1995	February 1996	March 2000
Algeria	Negotiations in progress		
Tunisia	June 1995	July 1995	March 1998
Egypt	June 1999		
Israel	September 1995	November 1995	
P.A.	December 1996	February 1997	July 1997
Jordan	April 1997	November 1997	
Syria	Negotiations in progress		
Lebanon	Negotiations in progress		

Source: Commission of the European Communities, “Annual Report of the MEDA Programme 1998. P: 7. & <http://www.euromed.net/>

The subsequent agreements between the EU and southern Mediterranean countries show the importance of this region to the EU. It can be argued that the EU had signed most of the earlier agreements only due to the pressure exerted by the second-party countries. Nonetheless, the EU would have not bowed to any pressure if the interests of the EU-members were not secured. The agreements concerned contribute to the impression of the relation between the EU and southern Mediterranean countries as being a love-

<sup>135</sup> Commission of the European Communities, *Annual Report of the MEDA Programme 1998*. COM (1999) 291 final. p. 7.

<sup>136</sup> Ibid.

hatred relation. The EU is keen to expand the markets for its exports in the region of the Mediterranean, and the economic development of the countries concerned would serve such aim. Nonetheless, the EU fears the consequences of economic failure in the region. Many member states endure problems resulting from the influx of immigrants from southern Mediterranean countries (North Africa in particular). These problems are either related to economic (unemployment) or cultural problems (difficult assimilation or integration of migrant communities). Although some EU member states are in need for migrant labour, the European are becoming choosy and are confining their requests to qualified labour for specific industries. Economic development in the countries of the Mediterranean would serve such aim, as well. In this sense, the cases of southern Mediterranean countries are almost identical. The differences lay in the level of their dependence on the EU as a destination for their exports, or their migrant labour. Lebanon, thus, can be seen as different from Tunisia or Morocco. The accession of Spain and Portugal into the EC did not affect Lebanon's exports to the Common Market as much as it affected North African countries. The latter were dependent on Europe for their agricultural and manufactured exports. Moreover, the issue of migrant labour in Europe was never as thorny with Lebanon as it is with North African countries. In the following section, the economic relations between the EU and Lebanon are investigated, to assess their development, and the implications for European business interests in the country.

## **2.6 Economic relations between the EU and Lebanon**

The establishment of the EC meant that relations between member states and other countries, like Lebanon, had a new regulatory body whose rules would affect the bilateral relations that were occurring before. The previous chapter has shown how France dominated the relations between Lebanon and Europe in the second half of 19<sup>th</sup> century and the first half of 20<sup>th</sup> century. European trade and investments flowing into Lebanon originated in France mainly. In this part, I examine the trade flow between the EU and Lebanon and the flow of capital (aid and investment) from the EU to Lebanon. I will also assess the impact of the agreements that over the time have come into being on the economic relations between the two parties. Inevitably, given the predominant role of trade in the relationship, much of the remainder of the chapter will be devoted to this

subject. It is important to discuss this fully to contextualise and provide proper consideration of the nature, and limits, of the relationship.

### 2.6.1 Trade (figures and agreements)

As a Mediterranean Arab country, Lebanon has always played the role of a gateway for EU trade with the inland Arab countries. This role is a continuation of the historical role played by Lebanon over previous centuries. However, Lebanon was not only an entrepôt for transit trade between the EC (or other industrialised countries) and the Arab countries. It was also an important market, which became a significant destination for the EC exports. Indeed, the EC has always provided the highest proportion of Lebanon's imports. This was always accompanied by a huge deficit in the balance of trade between the EC and Lebanon given the fact that Lebanon's exports to the EC countries were insignificant.

**Table 2.3 Lebanon's imports by country of origin between 1960-65 (LL 000)**

Year	EC	EFTA	Arab	Japan	US	East. Bloc
1960	338,215	318,801	149,973	15,936	125,849	53,664
1964	429,443	450,892	206,904		209,088	114,963
1965	579,920	244,915	232,464	39,963	181,069	130,570

Source: *Recueil de Statistiques Libanaises. Année 1965. Vol. 2*

Looking at the figures of Lebanon's foreign trade since 1960, two years after the establishment of the EC, we find that EC exports to Lebanon amounted to LL 338.215 million (US\$ 107.030 million).<sup>137</sup> The bulk of these exports came from West Germany, LL 103.444 million, followed by France, LL 92.018 million, and Italy, LL 70.434 million. These figures kept increasing until in 1964 when the total exports of the EC to Lebanon reached LL 429.443 million. West Germany and France stayed on top of the list with LL 125.620 million and LL 124.039 million respectively. Italy came slightly behind with LL 103.716 million. EC exports increased remarkably in 1965 (LL 579.920 million), this time thanks to the French whom doubled their exports to Lebanon (LL

<sup>137</sup>The exchange rate of US Dollar against the Lebanese Pound was LL 3.16.

251.657 million).<sup>138</sup> The EC exports were matched only by the EFTA exports at this time. EFTA exports exceeded the EC's exports in 1964 (LL 450.892 million). Among EFTA countries, Britain was the principal exporter to Lebanon. Its share in 1960 totalled LL 256.805 million. It jumped to LL 363.512 million in 1964, but decreased to LL 244.915 million in 1965.<sup>139</sup>

Lebanon's imports from other major industrialised countries did not match the size of imports from the EC. Japan lagged far behind in 1960 with LL 15.936 million total amount of exports to Lebanon. This amount increased gradually over the years but did not exceed LL 39.963 million in 1965. US exports to Lebanon fluctuated from one year to another starting with LL 125.849 million in 1960, rising up to LL 264.714 million in 1962, and then decreasing to LL 209.088 million in 1964, to drop in 1965 to LL 181.069 million.<sup>140</sup> Eastern Bloc exports to Lebanon did not represent any competition to the EC's either. The total amount of imports from the Eastern Bloc in 1960 was LL 53.644 million. This amount rose to LL 114.963 million in 1964 and to LL 130.570 million in 1965.<sup>141</sup>

The proximity of the Arab countries to Lebanon did not lead to any competition with the EC exports as these were heavily dependent themselves, as was Lebanon, on the industrialised countries. Arab countries' exports to Lebanon amounted to LL 149.973 million in 1960 and increased gradually to LL 232.464 million in 1965. Syria was the main supplier with a total of LL 45.215 million of exports in 1960. This amount increased gradually to LL 102.241 million in 1965. Iraq, Saudi Arabia, Egypt and Jordan came after.<sup>142</sup> Nonetheless, there was considerable diversity between Lebanon's imports from the EC and industrialised countries on the one hand, and the Arab countries on the other. Lebanon's major imports from the EC consisted of industrial and processed industrial supplies, capital equipment and consumer goods. On the other hand, Lebanon's imports from the Arab countries consisted mainly of petroleum products from the Gulf countries (Iraq and Saudi Arabia), and agricultural products from the neighbouring countries.

<sup>138</sup>: *Recueil de Statistiques Libanaises* (1965). Published by the Ministry of general planning, Department of Central Statistics. Beirut- Lebanon. p. 319.

<sup>139</sup>Ibid.

<sup>140</sup>Ibid. pp.317-319.

<sup>141</sup>Ibid. pp. 320-321.

<sup>142</sup>Ibid.

Meanwhile, the EC proved to be a minor destination for Lebanon's exports. These amounted to only LL 10.363 million in 1965, that is just 3 per cent of the value of EC exports to Lebanon in the same year. The EC imports from Lebanon were only marginally higher than the Eastern Bloc's imports and those of the EFTA countries'. Exports to the Arab world were seven-fold the size of exports entering the EC markets (LL 75.761 million). Although exports to the EC increased dramatically in the following two years, they were still far from closing the widening gap with exports to the Arab world. In 1965, exports to the EC reached LL 28.907 million – almost three-fold the record of 1960. However, Lebanon's exports to Arab countries reached LL 200.280 million.

**Table 2.4 Lebanon's exports by country of destination between 1960-65 (LL000)**

Year	EC	EFTA	East Bloc	Arab
1960	10,363	8,829	10,263	75,761
1964	22,053	15,092	18,474	126,986
1965	28,907	24,121	18,230	200,280

*Source: Recueil de Statistiques Libanaises. Année 1965. Vol. 2*

### **2.6.2 First non-preferential trade agreement**

Until 1965 trade between Lebanon and the EC member states was not regulated by any trade agreements. In 1962, the Lebanese government approached the EC to explore possibility of obtaining tariff concessions. At first, the request did not find favourable ground within the EC and, thus, bore no fruits.<sup>143</sup> However, it resulted three years later in the signing of a non-preferential trade agreement on 21 May 1965. This agreement was not confined to trade, but included also technical co-operation. As far as trade was concerned, the parties agreed on reducing non-tariff barriers. Meanwhile, technical assistance in the form of training and equipment was to be co-ordinated. The agreement came into force on 1 July 1968.<sup>144</sup>

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<sup>143</sup>Jawad. H, op.cit, p. 17.

**Table 2.5**      **Lebanon's exports by countries of destination, 1968-70 (LL000)**

Year	EC	Arab	EFTA
1968	34,498	334,063	31,006
1969	36,925		35,438
1970	43,423	410,373	28,452

*Source: Recueil de Statistiques Libanaises. Année 1973.No. 9*

By analysing the figures of trade between Lebanon and the EC after the non-preferential agreement was concluded, no significant increase in Lebanon's exports to the EC countries can be observed. The total amount increased by 7 per cent only in 1969. The increase reached 17.5 per cent in 1970. However, the total amount was still just LL 43.423 million. The principal destination for Lebanon's exports in the EC countries was Italy. In 1968 it received LL 10.983 million of total imports from Lebanon (31 per cent of total EC imports from Lebanon). This amount increased to LL 13.405 million in 1969 (36 per cent) and decreased to LL 13 million (29.9 per cent) in 1970. France followed suit in 1968 with LL 10.357 million (30 per cent), and LL 10.770 million (29.2 per cent) in 1969, while jumped to LL 12.673 million (29 per cent) in 1970. West Germany came third with LL 7.854 million in 1968 (22.8 per cent), and LL 7.578 million in 1969 (20 per cent), while its share increased to LL 9.413 million (21.7 per cent) in 1970.<sup>145</sup> These figures, despite the non-preferential agreement, did not exceed significantly the EFTA imports from Lebanon, which amounted to LL 31.006 million in 1968, and LL 35.438 million in 1969, to drop to LL 28.452 million in 1970. Britain imports from Lebanon amounted to LL 18.699 million in 1968 (60 per cent of EFTA imports), LL 20.135 million in 1969 (56.8 per cent) and LL 14.533 million in 1970 (51.1 per cent). Nonetheless, a comparison between the EC and Arab countries imports from Lebanon would clearly show the striking difference in value. Lebanon's exports to the Arab countries amounted to LL 344.063 million in 1968, and they jumped to LL 410.373 million in 1970. In both years, the EC countries' imports from Lebanon were equivalent to only 10 per cent of Arab countries' imports. Syria, on its own, imported from Lebanon more than the EC countries collectively did (LL 43.432 million). Given the small size of Syria as a market compared to the EC, the poor results of the non-preferential agreement are evident.

<sup>144</sup> Jawad. H, op.cit, p. 18.

<sup>145</sup> *Recueil de Statistiques Libanaises* (1970) op.cit, p. 304.



On the other hand, the EC exports to Lebanon increased after the agreement of 1965 came into force in 1968. It is worth mentioning that the EC exports had dropped in 1967 to LL 481.009 million, but in 1968 the figures leaped to LL 541.547 million. In 1969, it increased to LL 574.032 million, and in 1970 to LL 645.475 million. France and West Germany, followed by Italy, were the main exporters, as in the previous period. In 1970, France's share in the EC exports to Lebanon was 32.7 per cent (LL 211.030 million). West Germany's amounted to 30.6 per cent (LL 197.630 million), and Italy's share reached 23.2 per cent (LL 149.663 million). Britain kept its position as a major non-EC exporter to Lebanon, though its exports dropped from LL 364.250 million in 1967 to LL 272.300 million in 1968. In 1970, Britain's exports amounted to LL 258.168 million. Remarkably, Switzerland had the highest share of Lebanon's imports in 1970 amounting to LL 273.223 million.

### **2.6.3 Preferential trade agreement**

Not surprisingly the non-preferential agreement of 1965 did not satisfy the Lebanese government, not least since no substantial progress had been achieved in the field of technical assistance. Thus another agreement was concluded in 1972. This new agreement was a preferential one, and was mainly concerned with trade, and for a period of five years only. The EC granted tariff reductions up to 30-40 per cent to Lebanese exports to the EC, and an immediate tariff reduction of 45 per cent for industrial products (except textiles and petroleum products). Certain agricultural products such as citrus fruits, onions, garlic, bananas, mangoes, and avocados were given concessions as well. Lebanon, in return, granted the EC exports customs concessions ranging from 6 to 30 per cent. These were to be enforced according to an agreed timetable.<sup>146</sup>

**Table 2.6 Lebanon's exports by destination, 1972-73 (LL 000)**

Year	Total EC	France	Britain	US	Eastern Bloc	Arab countries
1972	96,259	52,750	44,962	71,636	57,154	679,289
1973	377,223 (222,223 exc. New members)	161,912	148,228 (now member of EC)	72,069	72,654	787,141

Source: *Recueil de Statistiques Libanaises Année 1973.No. 9*

<sup>146</sup>Jawad. H, op.cit. p. 19.

The pattern of trade between the EC and Lebanon changed enormously between 1971 and 1973 (time of signing the agreement). The accession to EC of new member states (Denmark, Ireland, and mainly, Britain) increased the volume of exchanges significantly. However, the EC-6 had increased their imports and exports to Lebanon, as well. The total Lebanese exports to the EC increased from LL 53.177 million in 1971 to LL 96.259 million in 1972, and leaped to LL 377.223 million in 1973. If we deduct from this the new member states' share (LL 154.605 million) we find that the EC-6 had increased their imports by nearly 131 per cent (LL 222.618 million). France, who increased its imports by 206.9 per cent (from LL 52.750 million in 1972 to LL 161.912 million in 1973) played a major role in this increase. Britain, as well, increased its imports from Lebanon by 229.8 per cent (from LL 44.962 million to LL 148.228 million). At that time, the EC became the main destination of the Lebanese exports in the Western world, leaving the US far behind with not more than 19 per cent of the value of the EC's imports (LL 72.069 million in 1973). The Eastern Bloc represented no competition to the EC, as its imports from Lebanon were equivalent to 19 per cent of EC imports (LL 72.654 million in 1973).

However, the major destination of Lebanon's exports remained the Arab countries. Those countries imported a total of LL 787.141 million in 1973. In comparison, the total EC's imports were equivalent to less than 42.8 per cent of value of Arab imports. Saudi Arabia, Libya and Kuwait were the three main Arab recipients. Indeed, these three countries imported, collectively, more than the whole EC did. On the other side, the EC enforced its position as the main exporter to Lebanon after concluding the preferential agreement. EC exports rose from LL 990.041 million in 1972 to LL 1,484.284 million in 1973. These figures include the exports of the new entrants (Britain, Denmark and Ireland) which amounted to LL 285.961 million. The main exporters were West Germany (LL 380.839 million); France (LL 361.915 million); Italy (LL 293.724 million) and the UK (LL 261.409 million). The US share in Lebanon's imports (LL 377.542 million in 1973) was very poor compared to the EEC's. The same was true for the Eastern Bloc and Arab countries' shares, which amounted LL 277.386 million and LL 346.071 million respectively.

**Table 2.7 Lebanon's imports by origin, 1972-73 (LL 000)**

Year	Total EC	West Germany	France	US	Eastern Bloc	Arab countries
1972	990,041	316,107	300,434	322,355	220,396	306,603
1973	1,484,284 (1,198,323 exc. New members)	380,839	361,915	377,542	277,386	346,071

*Source: Recueil de Statistiques Libanaises Année 1973. No. 9*

The EC exports to Lebanon in 1973 included various products such as: transport equipment; electric and non-electric machinery; crude and manufactured fertilisers; iron, steel and manufactures of metals; natural and manufactured gas (Italy); plastic materials; chemicals; medicinal and pharmaceutical products; meat products; and textiles and clothing.<sup>147</sup> On the other hand, Arab countries' exports to Lebanon were consisting mainly of petroleum and petroleum products from Iraq and Saudi Arabia, in addition to miscellaneous agricultural and manufactured products from the neighbouring countries.<sup>148</sup>

#### **2.6.4 First co-operation agreement within the GMP (1977)**

Due to its dissatisfaction with the agreements signed with the EC up to 1972, the Lebanese government approached the EC asking to negotiate a new agreement. Negotiations between the EC and the Lebanese government started in 1975, at the same time as other Mashreq countries. These negotiations culminated with the signing of a co-operation agreement of unlimited duration in 1977, based on Article 238 of the Treaty of Rome. The purpose of this co-operation agreement, as stated in Article 4, was mainly to promote:

- Participation by the Community in the efforts made by Lebanon to develop its production and economic infrastructure in order to diversify its economic structure. Such participation should be connected, in particular, with the industrialisation of Lebanon and the modernisation of its agriculture;

<sup>147</sup> Annual Bulletin for Arab countries foreign trade statistics, (according to SITC, R Divisions) 1970 & 1973. Council of Arab Economic Unity, General Secretariat, Arab Central Statistical Bureau. Cairo. October 1976. pp. 138-253.

- The marketing and promotion of sales of products exported by Lebanon;
- Industrial co-operation aimed at boosting Lebanon's industrial production through the following measures:
  - a- encouraging the participation by the Community in the implementation of Lebanon's industrial development programmes,*
  - b- fostering the organisation of contacts and meetings between Lebanese and Community industrial policy-makers, promoters and firms in order to promote the establishment of new relations in the industrial field in conformity with the objectives of the Agreement,*
  - c- facilitating the acquisition on favourable terms of patents and other industrial property by means of financing in conformity with Protocol 1 and/or by other appropriate arrangements with undertakings and institutions in the Community,*
  - d- permitting the removal of non-tariff and non-quota barriers likely to impede access to either market;*
- Co-operation in the fields of science, technology and the protection of environment;
- Participation by Community operators in programmes for the exploration, production and processing of Lebanon's resources and any activities which would develop these resources on the spot, and the proper performance of co-operation and investment contracts concluded for this purpose between their operators;
- Co-operation in the fisheries sector;
- The encouragement of private investments which are in the mutual interest of both parties;
- Exchange of information on the economic and financial situation, and on developments therein, as required for the proper functioning of the Agreement.

Concerning trade, the Agreement aimed at ensuring a better balance between Lebanon and the Community by increasing the growth of Lebanon's trade and improving the conditions of access for its products to the Community markets. Thus, quantitative restrictions on imports of industrial products originating in Lebanon were to be abolished by the time this agreement came into force. These products excluded those listed in Annex II of the Treaty of Rome. The Community reserved the right to introduce ceilings on imports of other products. Nevertheless, the Agreement stated that

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<sup>148</sup> Annual Bulletin for Arab countries foreign trade statistics, 1976. pp. 138-253

the ceilings provided for in Article 13 should be abolished not later than 31 December 1979.<sup>149</sup> With respect to agricultural products, custom duties on the imports originating in Lebanon were to be reduced by different rates. Reductions on citrus fruits ranged from 40 to 80 per cent; grapes, 60 per cent, and other products ranged from 40 to 80 per cent. However, the imports of some of the agricultural products were limited to specific periods of the year. For example, the imports of table grapes were allowed into the Community markets only from 1st of November to 14th of July. Taking into consideration that grapes are normally a summer crop, this meant that imports were allowed only in the off-season. The same applied to watermelons, from 1st April to 15th June. These were protectionist measures to avoid competition with the Community's agricultural products.

The Agreement included, in addition, a protocol on technical and financial co-operation. According to the protocol, the Community would participate, within the framework of financial and technical co-operation, in the financing of measures that would contribute to Lebanon's economic and social development. To this purpose, 30 million European units of account (eua) were allocated to Lebanon, within a period to expire on 31st December 1981. This amount was to be given in three forms: 20 million eua in the form of loans from the EIB (European Investment Bank) granted from its own resources on the terms set out in its statute; 2 million eua in the form of loans on special terms; and 8 million eua in the form of grants. This aid was to be used in the financing or part-financing of capital projects in the fields of production and economic infrastructure, aimed in particular at diversifying Lebanon's economic structure and, especially, at promoting its industrialisation and modernising its agriculture. It was also earmarked to finance technical co-operation as a preliminary or complement to capital projects drawn up by Lebanon and technical co-operation in the field of training.<sup>150</sup>

### **2.6.5 Implications for trade**

In the period 1978-79 the EC imports from Lebanon increased from around US\$ 41.5 million (5.1 per cent of Lebanon's total exports) to around US\$ 60.1 million (6.8 per

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<sup>149</sup>Text of the Co-operation Agreement between the European Economic Community and the Lebanese Republic. 1977. Articles 11, 13.

<sup>150</sup>Text of the Protocol 1, Co-operation Agreement, 1977. *op. cit.*

cent of Lebanon's total exports).<sup>151</sup> In 1980 it rose to around US\$ 71.3 million (LL 244.4 million).<sup>152</sup> The amount of Lebanon's exports to the EC deteriorated in the following years (US\$39.1 million in 1983) to end up with US\$ 60.41 million in 1985 (including Greece). In 1987, the figures went up again reaching US\$ 91.44 million (including Spain & Portugal).<sup>153</sup> However, this fluctuation can be attributed to the status of turbulence Lebanon went through in those years.

**Table 2.8 Lebanon's trade with the EC after the Co-operation Agreement: (US\$ million)**

Year	Imports	Exports
1978	846.5	41.5
1979	1,237.3	60.1
1980		71.3
1983		39.1 (inc. Greece)
1985		60.41
1987	1,623.38 (inc. Spain, Portugal)	91.44

*Source: Compiled by the author from various sources cited in the above paragraph.*

On the other hand, the EC exports to Lebanon kept increasing after the new co-operation Agreement came into force. They increased from US\$ 846.5 million in 1978 (37.7 per cent of total Lebanon's imports) to US\$ 1237.3 million (38.7 per cent of total)<sup>154</sup>, and it reached to US\$ 1,623.38 million in 1987 (including Spain & Portugal).<sup>155</sup> Thus, one of the main objectives of the co-operation Agreement, which was to ensure a better trade balance between Lebanon and the EC, was not reached. On the contrary, the gap widened between the imports and exports between the two parties concerned. Compared to other destinations, the EC's share of Lebanon's exports stayed very low. In 1979, it amounted to only 6.8 per cent of total Lebanon's exports, while Arab countries' share amounted to 73.1 per cent, and the Eastern Bloc share reached 11.1 per cent. The US share dropped to 1.6 per cent in the mean time. Even when the Arab countries imports from Lebanon started dropping its share stayed high (88.9 per cent).<sup>156</sup> In 1985, when the amount of the Arab countries imports dropped to US\$

<sup>151</sup> Statistical indicators of the Arab world for the period 1970-79, (Economic Commission for Western Asia (ESCWA) and the League of Arab States: 1981). p.135.

<sup>152</sup> Statistical abstract of the region of the Economic and Social Commission of Western Asia, 1978-1987. Twelfth issue. Baghdad. December 1989. p. 263.

<sup>153</sup> Arab Monetary Fund, Foreign Trade of Arab Countries, 1980-1990. No.8, 1991. p. 175.

<sup>154</sup> Statistical indicators of the Arab world. op.cit, p. 130.

<sup>155</sup> Arab Monetary Fund. op.cit, p. 178.

<sup>156</sup> Statistical abstract of the region. op.cit, p. 263.

253.19 million, the EC imports did not count more than 24.2 per cent of this number.<sup>157</sup> On the other hand, the EC's share of Lebanon's imports kept increasing. In 1979 it amounted 38.7 per cent of Lebanon's total imports.<sup>158</sup> While in 1983 it leaped to 48.4 per cent. Despite the drop in the figures of exports to Lebanon in 1987 (US\$ 783.02 million) the share stayed at 42.6 per cent of Lebanon's total imports.<sup>159</sup> Arab countries share, on the other side, was 15.7 percent in 1979.<sup>160</sup> It increased to 14 per cent in 1981, and then dropped to 8.5 per cent in 1985.<sup>161</sup>

The pattern of trade between Lebanon and the EU instigates many interpretations concerning the reasons behind its 'one-way' flow. We have seen that the Lebanese market has been historically dependent on imports, particularly from Europe. The size of Lebanon's exports was always minimal compared to its imports. Only at the time of the silk industry prosperity in the 19<sup>th</sup> century did Mount Lebanon's exports increase significantly. Otherwise, Lebanon imports from European countries, particularly after independence, were steadily increasing. The signing of trade agreements between Lebanon and the EC did not reverse the trend of trade. On the contrary, the gap between Lebanon's imports from the EC and its exports was still widening. This shows that Lebanon has always had a highly consuming market that always preferred European brands and products. Nonetheless, it gives the impression that Lebanon's industry was never competitive enough to enter the European markets. The agreements between the EC and Lebanon, particularly the 1977 Co-operation Agreement, gave some of Lebanon's industrial exports access to the Common Market, yet the size of exports did not change radically. In this sense, the European side cannot take the blame for the failure of Lebanon's exports. However, it can be suggested that the EC did not contribute significantly to reduce the imbalance in trade with Lebanon. The agreements with Lebanon never attempted to loosen the tight grip on the agricultural imports from Lebanon. The Common Agricultural Policy of the EC was always an obstacle in the way of agricultural imports. Moreover, although industrial imports from Lebanon were allowed into the Common Market, there was a list of products exempted from the permission (Annex I of the Treaty of Rome). The technical assistance envisaged in the agreements did not leave its prints on the size of Lebanon's industrial exports. This can

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<sup>157</sup> Statistical abstract of the region. op.cit, p. 175.

<sup>158</sup> Statistical indicators of the Arab world for the period 1970-79. op.cit, p. 130.

<sup>159</sup> Arab Monetary Fund, op.cit.

<sup>160</sup> Statistical indicators of the Arab World for the period 1970-79. op.cit.

be attributed to the political instability which hit the country during the mid-seventies and continued until the late eighties, which destroyed any attempt for industrial development in the country. It can also be suggested that the EC had shown no genuine commitment to assisting private European FDI in Lebanon that might have helped balance the Lebanese trade deficit.

## **2.7 EU capital flow into Lebanon**

The main funding institution in the EC (now EU) is the EIB (European Investment Bank), which was created by the Treaty of Rome in 1958. Other funding is also provided from the EEC budgetary funds. The EIB grants and guarantees long-term loans to enterprises, public authorities and financial institutions to finance projects contributing to regional development, projects for converting undertakings or creating fresh activities and projects of common interest to several member states or the Community as a whole. Moreover, the EIB, according to the Treaty, can finance operations in non-member states. Thus, the Bank funding has been gradually extended to various overseas countries under several agreements, conventions and decisions. The countries that benefited from EIB funding were: Greece; seventeen Associated African States, Madagascar, and Mauritius (AASMM); certain Overseas Countries and Territories (OCT); Turkey; and subsequently some thirty other states in Africa, the Caribbean and the Pacific, which are joint signatories with the AASMM of Lomé Convention, as well as Portugal and Yugoslavia.<sup>162</sup>

Arab countries (Mediterranean and non-Mediterranean countries) did not appear as recipients on the lists of the EIB loans until 1978. This was after the ratification of the Agreements between the EEC and Maghreb and Mashreq Mediterranean countries. Lebanon was the first and only Arab country to receive loans from the EIB in 1978 (apart from Sudan and Mauritania who were included in the African States and the Lomé Convention schedules). The first loan consisted of 3 million eua and was authorised in November 1977. It was part of the 20 million eua loan stipulated in the Financial Protocol of the Co-operation Agreement signed in 1977. The agreement stipulated 30 million eua to be given to Lebanon for the period up to 31 October 1978. This first loan was to part-finance the installation of three additional 70 MW generating

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<sup>161</sup> Arab Monetary Fund, *op.cit.* p. 178.



sets at *Jieh* thermal power station near Beirut.<sup>163</sup> In the mean time, the European Commission decided to set up an office in Beirut to house a permanent delegation to co-ordinate the implementation of the financial protocol.<sup>164</sup>

When the Lebanese government requested a better deal in 1981, it had already used up its entire EIB quota under the 1977-81 financial protocol and 18 per cent of its EC budgetary fund quota. Lebanon was looking for an increase in the amount of loans and grants under the coming financial protocol. The EC Commission supported this application by pointing out that under the new financial protocol, financial aid should be increased by 43 per cent to cover inflation and exchange rate losses.<sup>165</sup> In February 1981, a Lebanese delegation to Brussels required, among several demands, more long-term credits from the EIB needed for the industrial reconstruction.<sup>166</sup> The renewed financial protocol was signed in 17th June 1982 for a duration of four years, and allocated to Lebanon an amount of ECU 50 million. Of this, ECU 34 million were in the form of loans from the EIB and ECU 16 million from the Community's budgetary resources. The latter part was composed of ECU 5 million in loans on special terms and ECU 11 million in grants.<sup>167</sup> The EC funds were committed to the schemes of the Council for Development and Reconstruction (CDR), which was in charge of allocating the funds. Most of these funds were channeled into power projects in *Zouk* and *Jieh*.<sup>168</sup>

Compared to other Arab Mediterranean countries, Lebanon got a relatively high percentage of loans. With seven loans amounting to over ECU 42 million received in 1983, it was third only to Egypt (which got five loans amounting to over ECU 59 million) and Morocco (which received five loans amounting to over ECU 53 million). Tunisia and Algeria received five loans amounting to over ECU 36 million and two loans of over ECU 21 million respectively. The other Mashreq countries (Jordan and Syria) were far behind Lebanon. Jordan received eight loans that amounted to over ECU 21 million, while Syria received one loan amounting to over ECU 11 million.<sup>169</sup> However, consideration should be given here to the situation of Lebanon, and its need

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<sup>162</sup>EIB (European Investment Bank) Annual Report, 1977-78.

<sup>163</sup>EIB Annual Report 1978.

<sup>164</sup>EIU (Economist Intelligence Unit) Lebanon & Cyprus Report. 1st quarter 1979. p. 10.

<sup>165</sup>EIU, Lebanon & Cyprus report, 3rd quarter 1981, p. 9.

<sup>166</sup>EIU, Lebanon & Cyprus report. 2nd quarter, 1981. p. 12.

<sup>167</sup>Protocols to the EEC-Lebanon Co-operation Agreement and their basic texts. Office for official publications of the European Communities. Brussels 1990. p. 179.

<sup>168</sup>EIU, Lebanon & Cyprus Report. 4th quarter, 1981. p. 9.

for aid due to the civil war it was going through, and the consequences of the Israeli invasion in 1982. These events necessitated the dissemination of aid to Lebanon.

The EC has helped, to a certain extent, in the reconstruction plan of Lebanon that started after the Israeli invasion (1982) and the establishment of the new government under the newly elected president Amin Gemayel. In addition to the ECU 50 million that Lebanon was entitled to under the renewed financial protocol, the EC agreed, in 1983, to give around US\$ 37 million for Beirut's water supply system, and another ECU 50 million for special reconstruction aid.<sup>170</sup> Though the reconstruction process was hindered due to the resumption of the civil war, the EEC continued the support, most of which was a result of several Lebanese delegates to Brussels asking for help. In 1985, the head of the CDR signed an agreement with the EEC to provide US\$ 10.5 million in special loans and grants to help rebuild 350 schools damaged by the war. This covered nearly half of the funding required by the government's US\$ 24 million plan to repair 1000 schools throughout Lebanon. Furthermore, the EEC agreed to provide hundreds of tons of food in emergency food aid.<sup>171</sup>

The second financial protocol came to an end in 1986. Negotiations for renewing it took place, and resulted in the signing of the third financial protocol on 2nd December 1987 for a duration of four years, expiring on 31 October 1991. It amounted to ECU 73 million. Of this sum, ECU 53 million were in the form of loans from the EIB, ECU 20 million in the form of grants from the Community's budgetary resources, and ECU 1 million in the form of contributions to risk capital formation from the Community's budgetary resources.<sup>172</sup> In the same year, and in separate decision, the EC granted ECU 2.7 million as emergency aid to help the victims of the Camps War that took place between the Shia Amal Movement and the Palestinians in the refugee camps of Beirut and South Lebanon. The EC agreed, as well, to provide various types of food aid.<sup>173</sup> Therefore, similar to previous conditions, the EC aid was not confined to the financial protocols. In April 1988, the EC announced a grant and loan totalling ECU 2 million to build a printing plant for school books, which was to be run by a government agency

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<sup>169</sup>EIB Annual Report 1983.

<sup>170</sup>EIU, Lebanon & Cyprus. 2nd quarter 1983.p. 11.

<sup>171</sup>EIU, Lebanon & Cyprus. 3rd quarter, 1985. p. 15.

<sup>172</sup>Protocols to the EEC-Lebanon co-operation agreement and other basic texts. 1990. p. 187.

<sup>173</sup>EIU, Lebanon & Cyprus Report. 3rd quarter, 1987. p.14.

and provide books at only 60 per cent of the book sale prices.<sup>174</sup> On August 31, another ECU 8.6 million emergency aid was announced by the EC, of which ECU 5.3 million was for food supplies and the balance for tents, medicines, pumps, and generators. However, this assistance was to be channeled through non-governmental organisations rather than through the Lebanese government.<sup>175</sup>

However, it was suggested that due to the ongoing war during the 1980s, Lebanon did not use all the aid made available by the EC. Thus, by the end the war, Lebanon was eligible to claim all the previously allocated funds. In October 1992, the Lebanese government was granted a new aid package, which included the unclaimed funds and a fourth financial protocol covering the 1991-96 period. The total funds of this aid package were valued at ECU 350 million.<sup>176</sup>

The capital flow from the EU into Lebanon in the form of aid can be seen as a part of the EU global policy towards the Mediterranean region. As we established earlier, the economic development of the non-member Mediterranean countries was in the interest of the EU as it would help expanding the markets for EU exports. It would also serve in reducing labour migration into member states and enforce political and economic stability in the region. Moreover, the flow of aid can be described as a moral obligation towards these underdeveloped countries. Lebanon always imported most of its needs from the EU in exchange for little exports. It can be argued that aid has indirectly compensated for some of Lebanon's losses by contributing to reducing the deficit in Lebanon's current account. It was also hoped to instigate a process of industrial development to improve Lebanon's exports. Nonetheless, the civil war of Lebanon imposed special conditions on the relations with the country compared to other Mediterranean neighbours. Lebanon needed lots of aid during and after the war to rebuild the country and to resuscitate the malfunctioning economic sectors. Yet, the most important phase in the relations between the EU and Lebanon is the period following the civil war. This was accompanied by the significant development in the European approach towards the region of the Mediterranean represented by the Euro-Mediterranean Partnership initiative promoted by the EU.

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<sup>174</sup>EIU, Lebanon & Cyprus report. No.3, 1988. p. 15.

<sup>175</sup>EIU, Lebanon & Cyprus report.No.4, 1989. p. 15.

## **2.8 The Lebanon-EU Partnership Agreement**

As a signatory of the Barcelona declaration, Lebanon is expected to sign an Association Agreement with the EU, similar to the ones concluded between the EU and each of Tunisia, Morocco and Israel, P.A and Jordan. However, the negotiations that started in 1996 have not yet been concluded. The Lebanese government has required some concessions that are not included in the draft agreement. The agreement follows the same pattern of the agreements already signed with other Mediterranean partners. The political side of the Association agreement is not problematic, as it focuses on co-operation against terrorism and drugs, and seeks commitments on arms control. However, obstacles lay mainly in the economic and the social sides. On the economic side, the agreement aims at liberalising trade in goods and services in accordance with the planned Euro-Mediterranean free-trade area by 2010. Although this might sound encouraging as it removes obstacles for international trade, the Lebanese government has fears concerning some implications.

First, the accomplishment of a free-trade area means the reciprocal removal of all tariff and non-tariff barriers to trade in manufactured products within 10 years from the signing of the agreement. However, the free trade would not be extended to agricultural products. Although the Barcelona Declaration stated that trade in agricultural products would be progressively liberalised, this will still be done on a reciprocal preferential basis. Agricultural exports to the EU markets are still restrained by the EU Common Agricultural Policy.<sup>177</sup> Indeed, the Barcelona Declaration had stated that the liberalisation of trade in agricultural products would go as far as various agricultural policies allow.<sup>178</sup> This in fact institutionalises the restrictions on agricultural exports within the Euro-Mediterranean agreements. Nasser Saidi argued that this area of negotiations with Lebanon needs flexibility from the EU. By allowing Lebanese agricultural products access to the EU markets the cost of transition for Lebanon would be reduced. Meanwhile, the EU market would absorb Lebanon's products easily as the quantities involved would be negligible in the vast EU market.<sup>179</sup>

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<sup>176</sup> Lebanon, The Annual Business, Economic, and Political Review 1997-8. (Oxford Business Group, 1998) p.57.

<sup>177</sup> Ibid. p. 58.

<sup>178</sup> European Commission, Euro-Mediterranean Partnership. Report on Barcelona Conference 27-28 November 1995, p. 4.

<sup>179</sup> Saidi, N, Lebanon and the European Union at the Crossroads: An Interim Assessment of the Partnership Agreement, in Pathways to Integration, op.cit. p. 21.

Second, the financial support provided by the EU to the Mediterranean partners for structural adjustment purposes has a criterium that does not favour Lebanon. Saidi noted that the earmarked grants are allocated according to the country's size of population, its absorptive capacity (or willingness to undertake economic and social reforms), and per capita income (poverty). Lebanon in this sense is not in a competitive position. The population of Lebanon is small, while its economic system is already liberal with a limited public sector, and its per capita income is relatively high.<sup>180</sup> Saidi raised the point of reconstruction cost whose requirements need to be addressed within the EU approach.

Nevertheless, there are other economic problems preventing the Lebanese government from signing the agreement. However, it is the Lebanese government that needs to improvise solutions for such problems through a better fiscal policy. The first problem is the impact of a free-trade area on the government revenues. Import duties account for around 45 per cent of the Lebanese government revenues while more than half of those come from duties on imports from the EU. It is estimated that the losses to the Lebanese government would be around 35 per cent of its revenues. This would be due to the expected diversion in consumer interests toward reduced-price EU products.<sup>181</sup> The proposed solution for this problem is the introduction of a General Sales Tax to be replaced later by a Value Added Tax. However, some observers have pointed out that some custom duties are over 50 per cent while VAT would never reach these heights.<sup>182</sup> The other suggested solution to cover the loss from custom duties is the diversification of government revenues through much needed fiscal reform. This would include raising the share of direct taxation in government revenues as they have the lowest share of GDP in the region (around 14 per cent only).<sup>183</sup>

The other problem facing the Lebanese government is the dependence of local industry on the protection provided by the government through high tariffs. The removal of tariff barriers would mean rendering the local industry uncovered in a competition with now cheaper EU products. The industrialists seem to accept the fact that competition would be tough and thus Lebanese industry would have to improve the quality of its

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<sup>180</sup> Ibid. p. 22.

<sup>181</sup> *Lebanon, The Annual Business, Economic, and Political Review 1997-8*. Op.cit, p. 58.

<sup>182</sup> Author's interview with Sir. James Sillar. Assistant to the Secretary-General of the Arab-British Chamber of Commerce. London. 1998.

<sup>183</sup> Saidi, N, *Lebanon and the European Union....* Op.cit, p. 26.

production.<sup>184</sup> However, this does not offset the threat of job losses due to the expected closure of many local industries that would not be able to compete.

On the social side of the Partnership Agreement, the Lebanese government is expected to commit itself to a series of bilateral agreements with EU member states obliging it to re-admit refugees staying currently in Europe but who came originally from Lebanon. These would include nationals of other countries or stateless people who lived previously in Lebanon. It is feared that this would bring back substantial numbers of Palestinian refugees who left Lebanon during the war.<sup>185</sup> Indeed, even the repatriation of Lebanese refugees in Europe would create social problems in Lebanon due to the lack of job opportunities for the majority of them. Thus, the Lebanese government is unlikely to accept such condition.

### **2.8.1 Capital Flow: aid and investment**

The EU partnership Agreement with Lebanon is not entirely negative. The overall agreement is expected to be beneficial to the Lebanese economy, which eventually would adapt to the new system. The historical openness of Lebanon to the international community testifies to this effect. The EU financial and technical assistance is expected to help Lebanon in adjusting to the new system by modernising its economic sectors. So far, the EU has played a crucial role in financing the reconstruction programme, launched by the Hariri government in 1993. Capital flow in the form of aid has been dispersed through the EU Commission and the EIB. By the end of 1998 (Hariri's departure), foreign finance available for reconstruction reached US\$ 4,368 million. The EU's participation represented 17 per cent of the total amount. The EIB's share stood at 12 per cent while the EU commission's was 5 per cent.<sup>186</sup> In addition, some member states had agreed separate aid packages with Lebanon. Italy's aid represented 10 per cent of total foreign finance, while France's reached 7 per cent. Germany also took part in financing the reconstruction process by providing 3 per cent of the so far agreed foreign financing. Spain's share was 2 per cent. Therefore, the EU's total aid represented over 38 per cent of the total foreign financing. The remainder of the 'bill'

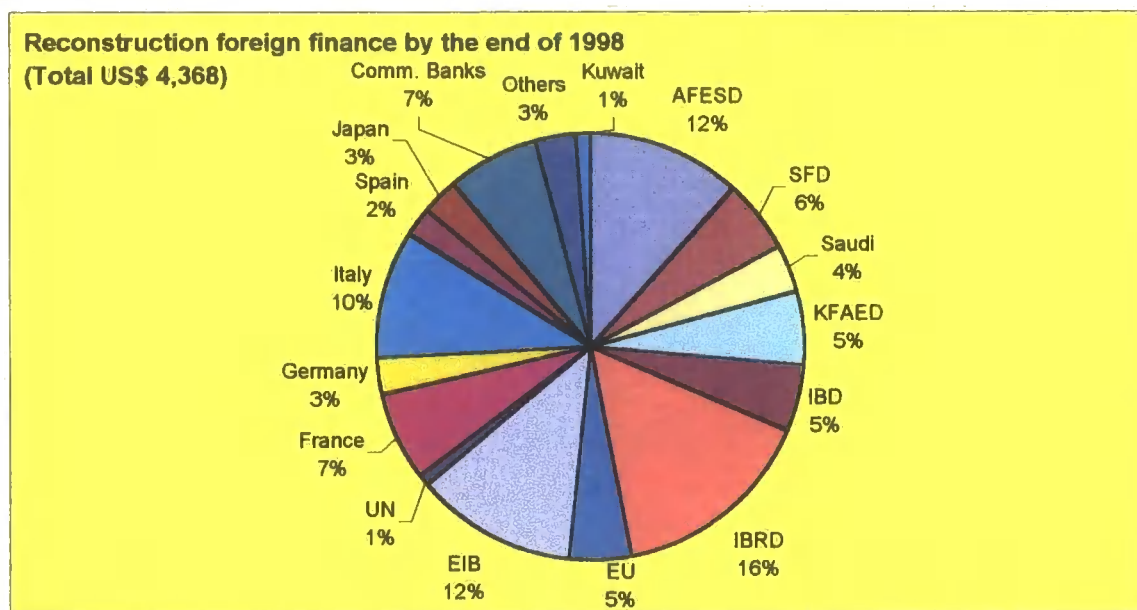
<sup>184</sup> Author's interview with Sa'ad al-'Owaini. Lebanese Industrialists' Association. Beirut. August 1998.

<sup>185</sup> Lebanon, The Annual Business, Economic, and Political Review 1997-8, op.cit, p. 58.

<sup>186</sup> Council for Development and Reconstruction (CDR). Progress Report, March 1999, p. 76.

was picked up by the IBRD (World Bank, 16 per cent), various Arab funds (28 per cent), and others.

**Chart 2.1**

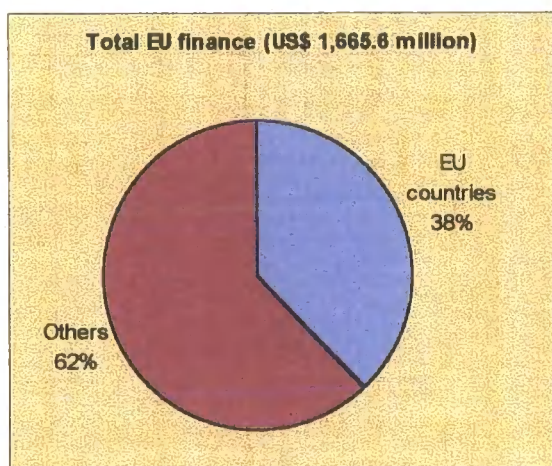


AFESD: Arab Fund for Economic & Social Development

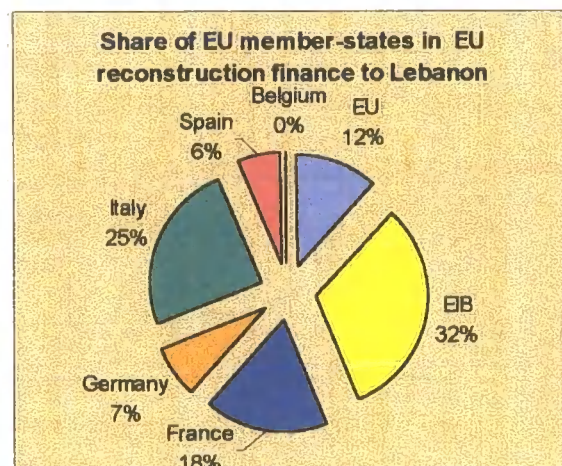
SFD: Saudi Fund for Development

KFAED: Kuwaiti Fund for Arab Economic Development

**Chart 2.2**



**Chart 2.3**



Source: CDR *Progress Report*.

**Table 2.9** EU finance for the reconstruction by the end of 1998 (*million US dollars*)

EU	EIB	France	Germany	Italy	Spain	Belgium
198.2	532.6	292.7	119.1	416.5	105	1.5

Source: CDR *Progress Report*, March 1999, p. 78.

Italy stood as the major donor amongst European countries. France, the traditional 'patron' of Lebanon, came second. However, a specific attention needs to be given to the form of aid provided by Lebanon's donors. The majority of the aid provided to Lebanon was in the form of loans and only a small fraction of it was in the form of non-repayable grants. By the end of 1998, the total amount of grants reached US\$ 551 millions, representing only 13 per cent of the overall foreign finance. Over a third of foreign finance was in the form of soft-loans, while the remainder was in the form of export credits, commercial and other types of loans. The major donor of grants, however, was the EU Commission. The amount of EU grants reached US\$ 191.4 million. The amount of grants has represented over 96 per cent of the EU aid to Lebanon's reconstruction. This can be explained as being part of the financial assistance allocated by the EU for the Mediterranean region as part of Euro-Mediterranean partnership. On the other hand, the EIB aid package did not include any grants at all. The EIB's policy is to provide loans only. The second major donor of grants to Lebanon was Saudi Arabia (US\$ 160.1 million). Only US\$ 19.5 million of Italy's aid package was in the form of grants. France was slightly more 'generous' with US\$ 24.8 million.

**Table 2.10** Form of foreign aid channeled into reconstruction

(US\$ million, unless otherwise states)

Type	EU	EIB	Saudi	UN	IBRD	Italy	France	Germany
Loans	6.9	532.6	....	.....	683.9	396.9	268	102.2
Grants	191.4	.....	160.1	46	1.4	19.5	24.8	16.8
% of grants out of total aid	96.6	0	100	100	0.2	4.9	9.3	16.4

Source: CDR. "Progress Report, March 1999". p. 80.



The EU aid was predominantly project specific. Hence, the involvement of the EIB in funding a remarkable number of major rehabilitation projects.<sup>187</sup> It could be argued that this type of conditional aid is more efficient when corruption is feared to exist. However, it was suggested that the EU aid was tied, as well. This was seen as a reason for the success of European firms in picking up a large proportion of reconstruction projects.<sup>188</sup> Indeed, a previous head of the CDR had spoken of some tied aid by which the EIB would demand allocating the job concerned to a European firm.<sup>189</sup> Although such conditions might impose on the recipient limited space to bargain for a cheaper price, it is certainly advantageous for European businesses in Lebanon. Moreover, the tied aid did not seem to be confined to the EIB aid only. The bilateral aid coming from EU member states was tied by conditions on allocating it to firms from these countries.<sup>190</sup> Although official documents were not available to support such arguments, this information can be supported by the correlation of the origin of a firm acquiring an infrastructure contract and the source of funding. It is not, therefore, surprising that French firms took most of projects funded by France.

As for the flow of EU private direct investments into Lebanon, particular emphasis was given to the role of these investments in boosting economic development. These are to be encouraged along with free trade in services through liberalised movement of capital and the free right for establishment. Indeed, the position of Lebanon with respect to the right for establishment is significantly different from the agreements with other partners.<sup>191</sup> The Association Agreement with Tunisia, for instance, stated that, "The Parties agree to widen the scope of the Agreement to cover the right of establishment of one Party's firms on the territory of the other".<sup>192</sup> It added that the Association Council would make recommendations for achieving this objective. In the case of Lebanon, the immediate free right for establishment would give the Lebanese economy a comparative advantage in attracting European service industries.<sup>193</sup> Saidi noted that these right are already "very generous" in Lebanon.<sup>194</sup> As for the liberalisation of capital movement,

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<sup>187</sup> *Lebanon, The Annual Business, Economic, and Political Review 1997-8*. Op.cit, p. 57.

<sup>188</sup> Ibid.

<sup>189</sup> Author's interview with Al-Fadl Shalak. Previous Head of the CDR. Beirut. Summer 1996.

<sup>190</sup> Ibid.

<sup>191</sup> Ibid.

<sup>192</sup> The text of the Association Agreement between the EU and Tunisia, signed in July 1995.

<http://www.euromed.net/>

<sup>193</sup> *Lebanon, The Annual Business, Economic, and Political Review 1997-8*. op. cit, p. 5.

<sup>194</sup> Said.N, in "Pathways to Integration". op.cit, p. 28.

Lebanon is a pioneer in the region in this sense, as the free movement of capital is one of the principles of its economy. As for the EU's role in encouraging the flow of EU private direct investments into Lebanon, this was declared in the Future Policy of the Euro-Mediterranean Partnership. The MEDA Programme stated that the financial assistance would be available to several types of beneficiaries including private operators and members of civil society.<sup>195</sup> Moreover, the EU has established special Business Centres in several Southern Mediterranean countries to provide assistance to local businesses. Although these Business Centres' assistance is non-financial, one of their tasks is to help local businesses in finding appropriate business partners from either the EU or any other country or region. This partnership may take the form of joint venture, business alliance, licensing, sub-contracting, technical co-operation agreement and technology transfer.<sup>196</sup> Business Centres have already been established in Egypt, Syria, Jordan, Gaza-West Bank, Morocco and Tunisia. However, with no obvious reasons for the delay, this service is yet to be established in Lebanon. In 1995, the EIB, whose funds mainly go to public sector infrastructure projects, has extended in 1995 "global loans" of ECU 3 million to the new Lebanese financial enterprise, Lebanon Invest SAL. These were to go into financing small and medium-sized enterprises in industry, tourism and service sectors. Priority was to be given to EU-Lebanese joint ventures.<sup>197</sup> Moreover, the EIB involvement in funding several projects in Mediterranean countries assures private businesses of the feasibility of these projects. Helen Kavvadia, of the EIB, stated that "the market generally interprets the Bank's agreement to fund a project as a result of sound appraisal and financial prudence".<sup>198</sup> This could encourage European firms to engage in business in the host country, mainly in projects funded by the EIB, as the financial risk in such cases is obviously minimal.

## **2.9 Conclusion**

Clearly, the southern part of the Mediterranean basin is of strategic and economic importance to the EU. The countries of this region are either suppliers of the EU's needs

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<sup>195</sup> Commission of European Communities, *Implementing MEDA 1996-1997 Report*. COM (1998) 524 Final. 14.09.98. p. 4.

<sup>196</sup> EUROMED Special Feature. Issue No 10 - 1 October 1999 <http://www.euromed.net/>.

<sup>197</sup> "Financing Provided By The EIB In The Non- Member Mediterranean Countries". <http://www.euromed.net/>.

<sup>198</sup> Kavvadia, H, *The Role of the European Investment Bank in the Mediterranean partners*. Paper presented at the 7th EURO-MED Information and Training Programme for Diplomats. Mediterranean Academy of Diplomatic Studies. University of Malta 19.11-22.11.1999.

of energy resources or a significant destination for its exports, or both. It is also a source of immigrating population, many of which EU countries fear their potential influx due to economic and political instability. France, in particular, which has utilised the abundance of cheap immigrant labour in the past, now tries to curb the influx of more of them. Therefore, enhancing the process of economic development in these countries would certainly be in the interest of the EU member states. This would help, on one hand, in expanding the markets for EU exports and, on the other, would encourage the labour force of southern Mediterranean countries to remain home and, thus, spare the EU the burden of migrant labour that might not fit European needs. Although some member states have registered their need to attract immigrant labour, these countries are looking for labour qualified for very specific industries. Therefore, European countries needed to improvise a comprehensive approach towards this vital and strategic region. It is surprising then to find that a coherent European economic policy towards the Mediterranean region was not considered until early 1970s, and that a comprehensive approach was not formed until the 1990s.

European business interests in the southern part of the Mediterranean are historically well established. The previous chapter has shown the strong trade relations between France, Britain and Italy on one side, and the countries of southern Mediterranean on the other. Lebanon was recognised as a major destination for exports and an entrepôt to the markets of the Arab region. These trade relations were enhanced after the establishment of the EC. It could be argued that the increase in demand for European products in the Lebanese market was the reason for Lebanon's high imports from the EC and not the special relations that have developed with the EC. Trade agreements between Lebanon and the EC were mainly responding to Lebanon's request for better access of its exports to the increasingly protected markets of European countries. This also applies to the other southern Mediterranean countries, which were struggling to get their exports into the common market of the EC. However, the majority of trade agreements signed between the EC and these countries, although improving the quotas of their exports, have widened the gap between the maximising exports of the EC and the slowly growing imports from the 'southerners'. This, nonetheless, could be considered good news for European businesses at the time. Their exports to the region were flourishing. In the case of Lebanon, the widening gap in its trade with the EC revealed the characteristics of Lebanon for having a high consuming market. It could be

argued, however, that although the trade agreements with the EC (later EU) did not offer massive concessions to Lebanon's industrial exports, the latter were not competitive enough to enter the Common Market. This describes the nature of Lebanon as being a non-producer country but a significant consumer. Agricultural exports would have been of great help in reducing the gap in the balance of trade. However, the EU was never willing to grant significant concessions, due to its rigid Common Agricultural Policy.

In the early 1990s, the Euro-Mediterranean approach brought a new element into the equation. Instead of preferential single-tracked trade agreements with the southern neighbours, the EU decided on a global approach by introducing the free-trade area. Accompanying this was the financial assistance allocated for joining countries to develop their economies and promote industrialisation. Lebanon is yet to sign the partnership agreement with the EU. The Lebanese government still fears the loss of its revenues generated through custom duties, which need to be replaced by other sources. Here again, the good news for European businesses is that their exports will be granted free access to the markets of the region giving them comparative advantage that are not available to other foreign imports. They will also be competing with poorer-quality locally produced goods.

Clearly, there was a predominance of trade in the economic relations between the EU and Lebanon. This was due to the lack of other business engagements between the two sides. The Lebanese government was always concerned about the biased balance of trade with the EU, and tried continuously to reduce the gap. However, the methods to strengthen the position of Lebanese exports, through technical and financial support to its domestic industry, did not achieve the anticipated success.

As for the EU's role in encouraging direct investments by EU private businesses, a generalising judgement of the EU policies cannot describe the situation. Clearly, the EU policies towards the region of the Mediterranean have never been constant. Therefore, the best way to assess the EU's role in encouraging EU businesses to operate in Lebanon is by looking at its policy through the different phases of the relation between the two parties. In the first phase that stretched from the establishment of the EEC until 1977 (the first Co-operation Agreement), the European Union did not develop a clear policy towards the region, including Lebanon. In other words, the EU can be described

as careless in its approach before the seventies. This was clear concerning trade, thus the same would apply to investments. In the second phase (1977-1990), the Co-operation Agreement hinted to the encouragement of private investments. However, nothing concrete materialised in this field. Nonetheless, it has to be said that this phase was characterised by the ongoing civil war of Lebanon. Any plans for encouraging direct investment would have been scrapped due to the high political risk that was prominent then. The third phase (1990s) is a suitable time to judge the role of the EU. By 1990 the civil war was ended and Lebanon was making its first attempts to rebuild the country. The EU's policy towards Lebanon was part of its new Euro-Mediterranean approach. Although described as very beneficial for European producers whose exports would be entering the markets of the southern countries freely, the new approach can be perceived of as being in the interest of European businesses interested in conducting business or investing in the region. The EU financial assistance earmarked for economic development in these countries has created opportunities for European firms. The MEDA Programme provides assistance for local small and medium-sized enterprises in finding a European partner. In other words, it helps European firms in finding southern Mediterranean business partners. In the case of Lebanon, the financial assistance has certainly created opportunities for European firms. The financing of some reconstruction projects has provided European firms with business opportunities, particularly when the EU or member state funding was conditioned to go to a European beneficiary. On the other hand, the fact that the EU and member states have been pumping capital into Lebanon could be seen as encouraging for private European businesses and investments. The EU and member states are very unlikely to be dumping their capital into a country without minimum assurances that it would lead to economic development. The high percentage of loans as opposed to grants within the European aid would indeed support this argument. A loan can be interpreted as a stake in the country which economic development would assure its repayment. However, there is always a combination of factors that would affect a firm's decision to establish business in a particular country. The role of the EU in the case of Lebanon can be auxiliary but certainly not decisive.

## **Chapter Three: The Lebanese Economy from Independence to Reconstruction**

*“Lebanon is the Middle Eastern market that is most familiar to the largest number of international companies doing business in the area...booming Beirut serves as a watch post or operational centre for the rest of the Middle East, or even as a base for manufacturing and exporting throughout the area”*

*Lebanon: A Switzerland of the Orient*<sup>199</sup>

### **3.1 Introduction**

This chapter examines the history of Lebanese economy, providing the reader with an historical, political and economic context for the following analysis of contemporary European business interests in Lebanon. The chapter aims to familiarise the reader with the development of the Lebanese economy through a study of the post-independence, civil war and reconstruction periods. For each period, the political context for economic development is given, since these have bearings on the direction and content of that development. At the end of each period, the salient points regarding the interests of foreign, and specifically European, businesses operating in Lebanon are summarised. It should be noted that this not a survey of European business interests in Lebanon during these periods. Rather it is an attempt to illustrate how the unique economic structures of Lebanon, including its tradition of *laissez-faire* policies and the predominance of services and trade over productive economic activities, have created an environment in which foreign business interests are largely confined to certain sectors of the economy and are not heavily engaged in direct investment. A more detailed analysis of the effects of specific government policies and economic developments at the present time in Lebanon will be offered later in the thesis. At this stage, however, the objective is to provide a broader and long-term context that will shed light on the general historical appeal (or lack of it) of the economy for foreign investors.

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<sup>199</sup> Business Prospects in the Middle East: Opportunities for Financing, Trade and Investment. Business International European Research Report. (New York: Business International, 1975) p.93.

### **3.2 The history of the Lebanese economy**

It is no exaggeration to say that every single Lebanese, ordinary or official, longs to see Lebanon being compared to Switzerland, or Beirut being named the 'Paris of the Orient'. However, the above statement, far from being contemporary, dates back to the heydays before the civil war, when Lebanon was enjoying a fast-track growing economy, with Beirut being the primary centre for business activities in the region. This prosperity was reversed by the turmoil through which Lebanon went. Foreign companies and individuals fled Lebanon, as the environment became hostile towards them. The end of the civil war in 1991 was accompanied by a Lebanese will to rebuild the devastated economy and attract foreign capital into the country. A full-scale reconstruction process was undertaken to rebuild the country's infrastructure, and to put the economy back on track. Attracting foreign investments was one of the major goals of the Lebanese government as the major source of capital inflows.

The interesting aspect of the Lebanese economy before the civil war is its peculiarity when compared to its neighbours: an economy that was furthering its openness while the surrounding countries were erecting barriers against outsiders. It was a stronghold of *laissez-faire* in a region where state-led, more accurately, state-controlled economies were becoming common. Many factors contributed to Lebanon's uniqueness when compared to its neighbours. History, people, location, nature, climate, environment, and neighbours all played a role in shaping Lebanon, politically and economically. To understand the specific characteristics of Lebanon's economy today, we need to look at the past to see how such a system was developed.

#### **3.2.1 The formation of Lebanon**

The establishment of the Lebanese entity preceded its independence in 1943 by only two decades. As mentioned before, the French mandatory authorities formed Lebanon in its present borders, in September 1920. Mount Lebanon, populated mainly by Christian Maronites and Druse, was enlarged to include the coastal towns of Beirut, Tripoli, and Sidon, in addition to Jabal Amil, the fertile Bekaa valley and Akkar plain. The French gave it a new name, 'Greater Lebanon'. However, a massive shaking of the demographic balance took place. The annexed parts were predominantly Muslim (Sunni in the towns and Akkar and Shi'a in Jabal Amil, while the Bekaa had mixed Muslim

population in addition to Christians). It also brought other Christian sects within the borders of the newly established entity. Maronites were no longer the majority, but, it was still said that the number of Christian inhabitants was just higher than their Muslim counterparts. The issue of representation in the parliament was settled on the ratio of 6 to 5 in favour of the Christians.

This process was not all easy going. The Muslim population had no interest in joining the new state. Sunni Muslims, in particular, were still hoping to join Syria in a Pan-Arab state. Describing the Sunni opposition, Meir Zamir noted that if the Maronites were the chief proponents of the idea of an independent Lebanese state, the Sunnis were its main opponents. "Their refusal to recognise Lebanon's existence as a legitimate independent entity separate from Syria posed the most difficult problem in the political development of modern Lebanon", he asserted.<sup>200</sup> The new entity was considered by Sunnis as being very artificial and established to strengthen the foreign powers' dominance. Moreover, it meant losing the privileges they had enjoyed in relation to their religious supremacy under the rule of the Ottomans. However, the opposition was not merely a result of Pan-Arabism or religious zeal among the Sunnis. It appears that economic interests played a major role in motivating the protest amongst the inhabitants of the newly annexed regions. Those regions did not have much in common with Mount Lebanon, as they had closer ties with the interior. Not surprisingly, this also involved Christian non-Maronite merchant families in the annexed regions, who had more interest in relations with the interior. Zamir noticed that Sunni merchants in Beirut and Tripoli always acted as middlemen in trade with the interior. A separation from Syria meant the loss of that role which was specifically theirs. Another reason for discontent among the Sunnis was the inequality in taxation, where the annexed regions were still paying the same rate of tax under the Ottomans while Mount Lebanon inhabitants enjoyed the same low rate they previously had. Sunnis felt they were being exploited by the Maronites as they were paying to fund the national budget, most of which was spent in the mountain.<sup>201</sup>

Zamir drew an explanatory picture of the Lebanese problem with the Maronites' and Sunnis' attitudes as the opposite extremes, while other major groups swung in the middle. "Greek Orthodox, Druze, and Mutawallis (Shi'a) adopted a more moderate position between these two extremes", he noted. Their positions depended on how their

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<sup>200</sup> Zamir, M., *The Formation of Lebanon*. op.cit. p.126.



notables perceived the best way their interests could be protected. This explains the Greek Orthodox' dubious position towards the new entity. Their economic interests in Syria and their dislike of the Maronites' supremacy contributed enormously to this attitude. The Druze were part of Mount Lebanon and "had a certain attachment to the notion of Lebanon as an independent entity". However, they feared the Maronites' domination. They were divided between proponents of the Lebanese entity and opponents who wanted the Pan-Arabist option. The Shi'a notables rejected annexation by sticking to the Pan-Arabist question. However, when the notion of an Arab state faded with Faisal's defeat, they realised the importance of co-operation with the French. At the end of the day, the Shi'a did not share with the Sunnis their ideal of an Arab state, believing that in such a state they would be treated as inferiors.

Economic prosperity under the French mandate brought all the conflicting groups to terms with the new state. "It created the necessary climate for integrating the inhabitants of the annexed areas, especially their economic and political elites, thus enabling them to resist pressure and temptation from outside".<sup>202</sup> Kamal Hamdan said that Beirut had gained great importance in the country's politics and economy at the expense of the mountain. "The economic development affected the Lebanese attitudes towards each other, and the growth advocated the notion of belonging to the same political and economic sphere, mainly in Beirut" he suggested. The rise of a substantial educated urban middle class from different communal groups played a major role in this process. "With the distinguished development in business, the rise of a new bourgeoisie, and good education, the inhabitants of Beirut found themselves less willing to accept an outsider authority or any hierarchical religious authority", Hamdan added.<sup>203</sup> Zamir considered Greater Lebanon an undoubted economic success. "With its new territories and ports and with Beirut, which became the economic and administrative centre for the whole of Syria, the country offered new economic opportunities which Lebanese entrepreneurs were quick to exploit". Merchants' fears of separation from Syria evaporated as no customs barriers were installed between the two countries<sup>204</sup>. The concept of Lebanon was finally accepted by its inhabitants. A growing class, ironically

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<sup>201</sup> Ibid. p 127-128.

<sup>202</sup> Ibid, p.137.

<sup>203</sup> Hamdan, K, "*al-azmah al-lubnania: a-tawaif a-dinyah, a-tabaqat al-ijtimaiyah, wal-hawiyah al-wataniyah*" *The Lebanese Conflict: Religious Sects, Social Classes, and National Identity*. (Beirut. 1998) p. 62.

<sup>204</sup> Zamir, M, op.cit. p. 137.

coming mainly from the Maronites and Sunnis, the previous two extremes, was developing a common interest in the new state. They struggled together to gain independence from France.

### **3.2.2 The economy after independence**

The capitalist system which started to develop during the second half of the 19<sup>th</sup> century and which was strengthened under the French mandate carried on after independence. The trend in economic activities was towards the services that had flourished during mandate. Owen considered that the prosperity in the services sector, since the mandate period, benefited from the decline of the silk industry. This latter was “allowed to die off from want of support from the French and from financiers of Beirut and from absence of an alternative market to Lyon in the Syrian hinterland”.<sup>205</sup> The policy of low tariffs and the development of new infrastructure helped to expand trade, building and the new industry of tourism.<sup>206</sup> This system was consolidated after independence in 1943.

However, the economic prosperity that Lebanon enjoyed in the three decades after independence also benefited considerably from various changes in that period:

- First, the expenditure of the allies during World War II in Lebanon created a sort of capitalisation that funded economic activities, not only in services but also in other productive sectors and infrastructure.
- The closure of the port of Haifa to Arab business, after the 1948 war, ended its competition with the port of Beirut, and left the latter as the main entrepôt for trade between Arab countries and overseas.
- The flow of fugitive capital from Palestine after the creation of Israel, and from other Arab countries after the changes in their regimes over 1950s, found its way to Beirut. The overthrow of traditional regimes in Egypt, Iraq and Syria and the subsequent nationalisation trend caused capital flight. Lebanon was the major destination.
- The Palestine problem caused the influx of a significant number of Palestine refugees into Lebanon. A substantial number of the newcomers had notable expertise in banking

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<sup>205</sup> Owen, R, The Political Economy of Grand-Liban 1920-1970. In Owen, R, Essays on the Crisis in Lebanon. (Ed), (London: 1976) p. 26.

<sup>206</sup> Ibid.

and other services that Lebanon benefited from. In addition, the agricultural sector gained a huge supply of cheap labour.

- The abolishing of the customs union with Syria in 1950 freed the Lebanese merchants' hands in trade. This union, established by the French during the mandate period to organise the foreign trade of the two countries, became unsuitable to accommodate the different interests of the two partner countries. It became clear that the Syrian bourgeoisie was in favour of trade barriers as it was involved in domestic production, unlike the Lebanese bourgeoisie who was traditionally tied to trade with overseas.

- The later increase in oil production offered Lebanon considerable revenues from duties imposed on oil pipes. Moreover, a lot of the wealth generated from oil in the Gulf countries was flowing into Lebanese banks as Beirut provided the most advanced and the only free banking system in the region. This was enhanced by decreeing bank secrecy in 1956. Other Arab investments went into property and real estate.<sup>207</sup>

The economy grew rapidly during the three decades after independence. Economic annual growth was estimated at 7 per cent in the 50s and 6 per cent during the 60s and early 70s. This was accompanied by very low rates of inflation that did not exceed 3 per cent per annum during the same period.<sup>208</sup> However, this growth was not evenly distributed among the sectors. The tertiary sector, comprising trade, banking and services grew much faster than the other productive sectors. Commercial activities increased by 56.7 per cent between 1950-57, and in 1957 contributed a third of GNP. Nevertheless, the period extending till the burst of the civil war in 1975 witnessed development in all sectors, albeit disproportionate.

Agriculture was affected by the decline in demand for silk, which reduced its importance as a productive sector considerably. There was no policy to support the ailing sector whose contribution to the GNP in 1957 was 15.6 per cent, when almost half of the labour force was engaged in agriculture.<sup>209</sup> Eventually, rural-urban migration was a result of the decline in agriculture. The percentage of inhabitants of rural areas dropped from 49.25 per cent in 1959 to 38.8 per cent in 1970.<sup>210</sup> The trend was towards Beirut and its suburbs, where migrants looked for opportunities in the prosperous sector

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<sup>207</sup> Hamdan, K, 1998. pp. 86-89, Owen, R, 1976. pp.27-28, Taqi a-Din, S, 1977. p.90, and Gholmyah, N, 1976. p.163.

<sup>208</sup> Hamdan, K, 1998. op.cit, p.91.

<sup>209</sup> Owen, R, 1976. op.cit, p.28.

<sup>210</sup> Hamdan, K, op.cit, p.94.

of services. The gap between rural and urban population figures was widened by 1974 at which point the population of rural areas accounted for only 14 per cent of the country's population.<sup>211</sup> Israeli attacks on southern Lebanon and Western Bekaa in retaliation against Palestinian guerrillas contributed hugely to this change. Many villages near the borders became uninhabitable and any farming activities there had been came to a halt. However, a positive contribution of agriculture was in its being a major source of foreign currency, constituting around 50 per cent of total exports. Fruits and vegetables had the highest share of exports to Arab Gulf countries. However, its share in GDP was around 10 per cent early in 1970s, just before the civil war.<sup>212</sup>

Industry lagged behind the services sector in the immediate post-independence period, as it did not receive similar preferential treatment from the government. With little protection through low external tariffs, and uncertain power supplies, industry had little chance to prosper. Industrialists lacked the political power to persuade the government to pursue pro-industry policies.<sup>213</sup> However, in the late 60s and early 70s, the industrial sector developed rapidly. Hamdan explained this as a result of saturation in the tertiary sector, after which the Lebanese bourgeoisie embarked on a new process to extend the traditional role they had played. This role, which had previously by and large focused on financial and trade mediation, now came to include industry. The Lebanese bourgeoisie wanted to emphasise its role as the main mediator between the Arab markets and the rest of the world.<sup>214</sup> Marwan Iskandar attributes the prosperity in the industrial sector to several reasons. These included the relative political stability in the country compared to the neighbouring countries; a large supply of low-cost industrial labour; subsidised fuel and electricity; easy-credit terms; a strong and stable Lebanese pound (which helped reduce the cost of imported raw materials and machinery); growing export markets (especially in the Gulf countries); and effective trade protection for a number of industries.<sup>215</sup> Iskandar's analysis shows that some problems that hampered industry during the 1950s seemed to have been solved; mainly the power supply and tariff protection. Nevertheless, it is the bourgeoisie's interest that granted the

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<sup>211</sup> Jaber, T, "*al-qita' a-zera'i fi lubnan, tahlyl wa afaq*" *Agricultural Sector in Lebanon. Analysis and Prospects*. (Beirut, LCPS: 1997) p.21.

<sup>212</sup> Lloyds Bank Economic Report. *Lebanon*, 1974. p.8.

<sup>213</sup> Owen, R, 1976. op.cit, p.28.

<sup>214</sup> Hamdan, K, 1998. op.cit, p.93.

<sup>215</sup> Iskandar, M & Baroudi, E, *The Lebanese Economy in 1982-83*. (Beirut, Middle East Economic Consultants: 1984) p.31.

industrial sector some kind of assistance. Moreover, there had been some drastic changes in the government policies during the 1960s- the period that is known as *Chehabist*<sup>216</sup> in Lebanon's contemporary history. These changes are to be discussed in the following section. Meanwhile, figures show that the growth in industrial production jumped from an annual rate of 5 per cent in the 1950s to 10 per cent in the 1960s.<sup>217</sup> The share in the GDP was 13 per cent in 1968, and indeed jumped to an estimated 20 per cent in 1974-1975 on the eve of the civil war. Nominal capital tied up in industrial establishments reached LL 25 bn in 1974 compared to LL 1 bn in 1968, while industrial exports increased from 54 per cent of total exports in 1967 to 75 per cent in 1974.<sup>218</sup>

The tertiary sector, which comprised trade and services (financial and non-financial), had the highest rate of growth, and contributed the biggest share of Lebanon's GNP in the post-independence period. Between 1950 and 1962, commercial activities alone contributed to between 29 and 31 per cent of GNP, while services' share was around 10 per cent, and financial sector between 4 and 7 per cent. A'yash pointed out that when looking at services in its broad concept, i.e. including trade, tourism and finance (tertiary sector, according to his definition), it is possible to say that this sector represented 2/3 of Lebanon's GNP. Trade represented the major component of Lebanon's GNP (around 30 per cent). Despite the chronic deficit in the balance of trade, commercial activities involving transit trade flourished remarkably in the post-independence period. The French determination during the mandate period to strengthen Beirut's position as the *entrepôt* of the region, and the bourgeoisie's commercial interests established a strong infrastructure for transit trade. The enlargement of the port of Beirut and the Beirut-Damascus road were developed mainly for this reason. This role was not new for Beirut: the city had been established since the early 19<sup>th</sup> century as the *entrepôt* for the interior parts of Syria, and later to serve the region under the French mandate. However, transit trade flourished rapidly after the neutralisation of the port of Haifa following the creation of Israel. Most Arab commercial activities were diverted through Beirut. The post-independence governments worked on maintaining this position by facilitating transportation. Later, the closure of the Suez Canal in 1967 gave Beirut a still better position. Indeed, the only maritime route between Europe and the Gulf countries was again the maritime tour around Africa. Beirut offered a more cost-

<sup>216</sup> Chehabism is named after Preseident Fou'ad Chehab who was in power between 1958-64.

<sup>217</sup> Hamdan. K, op.cit, p.93.

effective alternative for these shipments through its transit trade facilities. Transit traffic was estimated at 5.3 tons in 1974.<sup>219</sup> Moreover, Lebanon was the outlet for the Iraqi and Saudi oil on the Mediterranean. Petroleum traffic through Tripoli (Iraqi oil outlet) only mounted up to 9 million tons in 1973.<sup>220</sup> The duties imposed on these transactions provided the Lebanese government with substantial revenues. Moreover, these activities created employment and business opportunities. The port of Beirut always had the problem of congestion, a proof of the high density of trade taking place. This could explain the plans to enlarge the facilities just before the beginning of the civil war.

Financial services included banking, insurance, the financial market and the stock exchange. A'ayash noticed that the vast growth in the financial sector in the 1960s can be attributed to a major expansion in banking activities.<sup>221</sup> It shows indeed how Lebanon started reaping the benefits of changes in the neighbouring countries, and how Beirut was strengthening its position as the financial centre of the Middle East. The number of banks operating in Lebanon reached 81 by 1974, a relatively high number for a population then only just above 3 million.<sup>222</sup> However, banking services were not targeted at Lebanese clients mainly, but were operating regionally by serving other Arab countries. There was an abundance of capital to be managed. This was based on the fugitive-capital influx into Lebanon after the political changes in the surrounding Arab countries, and the capital surpluses resulting from the increase in oil production in the Gulf countries. This explains the impressive presence of foreign banks in Lebanon, which in 1974 reached 17 banks, including five Arab banks. Meanwhile, Lebanese banks with a majority of foreign shareholders mounted to 26, four of them with an Arab majority.<sup>223</sup>

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<sup>218</sup> Iskandar. M, 1984. op.cit, p.32.

<sup>219</sup> EIU, *Lebanon, Annual Supplement*, 1976. p.21.

<sup>220</sup> Ibid.

<sup>221</sup> A'ayash. G, "*Azmat al-maliyah al-'amah fi Lubnan*" (The crisis of Lebanon's public finance) (Beirut 1997) p.31.

<sup>222</sup> The population was 3,065 thousands in 1974, according to the World Bank Annual Report, 1976. p:44.

<sup>223</sup> Balance Sheets of the Banks, Produced by the Association of Banks in Lebanon. 1983.

**Table 3.1 List of foreign banks operating in Lebanon before the civil war**

No	Foreign bank	Arab	Non-Arab	Country
1	Banque di Roma		*	Italy
2	Banque Nationale de Paris (Intercontinentale)		*	France
3	The British Bank of the Middle East		*	Britain
4	Algemene Bank Nederland N.V.		*	Netherlands
5	The Chase Manhattan Bank		*	US
6	First National City Bank		*	US
7	The Chartered Bank		*	US
8	Bank Saderat Iran		*	Iran
9	Moscow Narodny Bank Limited		*	USSR
10	Bank of America		*	US
11	Habib Bank Limited		*	
12	The Bank of Nova Scotia		*	Canada
13	Arab Bank Limited	*		Jordan
14	Rafidain Bank	*		Iraq
15	Saudi National Commercial Bank	*		Saudi Arabia
16	Jordan National Bank	*		Jordan
17	Arab African Bank	*		

*Source: Association of Banks of Lebanon, Balance Sheets of the Banks, 1974.*

Another prosperous part of the financial services sector was the insurance sector, which attracted many foreign companies. In 1967, the number of foreign insurance companies was 110 while local companies numbered only 12. Competition was very tough between those companies, particularly small ones.<sup>224</sup> Possibly, this competition played a major role in the continuous withdrawals and newcomers among firms operating in this sector.

Non-financial services included mainly tourism, but also education, health care, and transport. The tourism sector developed rapidly during the sixties. Its share in the GDP was around 10 per cent in 1964 but reached 19 per cent by 1975.<sup>225</sup> More than 40,000 people were directly or indirectly employed in the sector. During this period, Lebanon had managed to establish itself as a perfect destination in close proximity to both Europe and the Arabian Peninsula. It has been said that "at a time when intercontinental travel still involved stop-overs, Beirut was a major stop on the routes to the Far East".<sup>226</sup> The social environment of Lebanon provided an apparent level of freedom that played a major role in attracting visitors from the Arab world. "For thousands of visitors from the

<sup>224</sup> Iskandar.M, 1984. op.cit, p.249.

<sup>225</sup> Lloyds Bank Country Report, Lebanon 1979. p:16.

more traditional Arab Gulf, Lebanon offered the freedom of Europe just a few hours' flight away".<sup>227</sup> In fact, Lebanon was already established as a perfect place for summer breaks in the Arab world. Even earlier in the century, many Arab visitors used to spend summer seasons in Mount Lebanon. The increase in the wealth of Gulf countries boosted Lebanon's tourism industry as many Arabs bought property in Lebanon, particularly in the mountains, to spend their summer time there. The influx of tourists provided Lebanon with substantial amounts of foreign exchange that helped to offset the deficit in the balance of payments.

Tourism and transit trade required a strong infrastructure to be built. Transport is normally one of the major demands. As mentioned earlier, the port of Beirut was working beyond its capacity, and plans were ahead to enlarge it. A new airport was built in the 1960s, to handle 2.8 million passengers and 145,897 tons of cargo in 1974. The EIU reports described it then as "one of the most important airports in the world".<sup>228</sup>

### **3.2.3 Economic policies after independence**

In a famous quote used by Nadim Shehadi, the Belgian expert Paul Van Zeeland commented on the way the economy functioned in Lebanon by saying, "I don't know what makes the economy work but it's doing very well and I wouldn't advise you to touch it".<sup>229</sup> He noticed that "invisibles" constituted most of the national income. Ideas of a liberal economy were indeed consolidated after independence. This was understood as the marginalisation of the government's role in the economy leaving that to private entrepreneurs. It was the liberal *laissez-faire* system that Van Zeeland advised not to touch, keeping the role of "invisible hands" pivotal in the growing tertiary sector while the state kept out of it. Shehadi considers that a *laissez-faire* system was an oddity in the post World War II world when a dirigiste fashion was spreading, advocating more state intervention and planning in the economy. Lebanon, however, remained one of the few remaining "citadels of truly *laissez-faire* capitalism".<sup>230</sup>

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<sup>226</sup> Lebanon, The Annual Business, Economic and Political Review 1997-98. "Skiing in the Morning.." Tourism Sector Overview. op.cit, p. 171.

<sup>227</sup> Ibid.

<sup>228</sup> EIU, Country Profile, Lebanon, 1976. p. 21.

<sup>229</sup> Shehadi. N, The Idea of Lebanon: Economy and State in the Cenacle Libanais 1946-54. Papers on Lebanon. No. 5. 1987. (Oxford, Centre For Lebanese Studies) p. 3.

<sup>230</sup> Ibid, pp.4-6.



The Lebanese government in the first decade after World War II intervened very little in the economy. By not leading the economy, it left the grounds for the private sector to operate freely. It provided a deflationary, free and stable monetary structure, and liberalised foreign exchange. Low taxes and low tariffs were preserved, protecting only those industries which were already in production. No attempt was made to contain the high propensity to consume imported goods.<sup>231</sup> Indeed, this policy of government retraction was inherent in the thoughts of the founders of the constitution. Michel Chiha - a principal author of the 1926 constitution - wrote in 1952 suggesting that "exaggeration in government intervention would make life more difficult. Private administration is more active and productive than government administration in Lebanon".<sup>232</sup> A'yash concluded that these thoughts surely had their impact on public finance. The government's budgets were very compatible with the idea of "non-interventionist government, non-interventionist budget". This might explain why the government revenues were much higher than its expenditure between 1951 and 1961.<sup>233</sup>

Indeed, the government economic policy was affected by the input of the different presidents who took office in the post-independence period. Non-interventionism was preserved under Bishara Khouri - the first president after independence. Under the subsequent president, Camille Chamoun, the government spent extravagantly on some development plans. A new airport was built, in addition to better transportation facilities and a big sports complex. Owen noted that the real needs of the people in rural areas were not considered, and the benefits went to that small group of contractors that had special connections with the president. He also noticed that the Lebanese government was not concerned about strengthening its armed forces. The army stayed small in size as its number rose from 6000 in 1952 to just 10,000 in 1956-57.<sup>234</sup> Under Army Commander Fou'ad Chehab, who was elected as president after Chamoun was forced out of office, the government's economic policy changed drastically. This was due to the turmoil Lebanon went through in 1958, when Muslims, mainly Sunnis, revolted against Chamoun's government after he sought to extend his term, an act which was against the constitution and which his predecessor had tried before but failed. The upheaval ended when the US Marines landed on the shores of Beirut upon Chamoun's

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<sup>231</sup> Ibid, p.7.

<sup>232</sup> A'yash.G, op.cit. p. 32.

<sup>233</sup> Ibid.

<sup>234</sup> Owen. R, 1976. op.cit. p.27.

request.<sup>235</sup> Chehab thought that, although Pan-Arabism contributed enormously to the Muslims revolt, encouraged by the unity between Egypt and Syria under Nasser, socio-economic inequality had certainly played a pivotal role in the affair. In fact, income was unevenly distributed between the different classes and regions. Owen noticed that commerce, which contributed to almost a third of the national income in 1957, employed only 12 per cent of the working population. By contrast, agriculture, which contained almost half of the labour force, contributed only 15.6 per cent. He concluded that the lower-class urban Muslims felt their community was discriminated against and impoverished by the country's wealthy, predominantly Christian, rulers.<sup>236</sup> Chehab introduced a new economic policy. He pursued an economic development policy in which the government was at the centre. He was the first to introduce planning into the Lebanese system using a French survey mission (IRFED).<sup>237</sup> He extended roads and electricity to rural areas; increased the government's expenditure on education by which schools were built in rural regions; and commenced a social security programme. He obviously was not happy with the free hand given to the private sector without any regulations. One of his major achievements was the establishment of the Central Bank to regulate the banking sector. Chehab introduced other governmental bodies, mainly the Council for Civil Service and the Central Inspection Institute. Here also, more regulation was being injected into the system. A major difference with his predecessors' policies was that Chehab focused on building the military power of the government. The army was expanded to 15,000 men and the police were strengthened. Coming from a military background obtained through the army, Commander Chehab already had his own system on which he could rely. In fact, the Deuxième Bureau -his new intelligence service- was pivotal in supporting the regime against any trouble.

### **3.2.4 Summary: the economy before the civil war**

Lebanon was witnessing a remarkable economic prosperity on the eve of the civil war, in April 1975. This prosperity was due to the economic boom that occurred over the 1960s, and was continuing despite its ups and downs.<sup>238</sup> The economy was growing

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<sup>235</sup> Robert Fisk argues that by the time US Marines landed the trouble was already finished and they found traveller-vendors trying to sell them various goods ranging from chewing gums to rugs!! In Fisk, R, *Pity the Nation, Lebanon at War* (Oxford: O.U.P., 1991).

<sup>236</sup> Owen, R, 1976. op.cit, p. 28.

<sup>237</sup> Institut International de Recherche et de Formation Education au Développement.

<sup>238</sup> The 1967 war consequences, and the crisis of bankruptcy of Intra Bank in October 1966.

rapidly, with 5 per cent growth average per year during 1960-70 and then accelerated to 9 per cent per year in 1970-75. GNP was growing as well, by 3 per cent per year since 1960, and was estimated at US\$ 1,070 per capita in 1974<sup>239</sup> (the World Bank figures were US\$ 700 in 1974, and US\$ 900 in 1975, while it was US\$ 1,080 in 1976, estimated on the 1972-74 base period).<sup>240</sup> Despite the fact that the industrial and agricultural sectors did have a share in the country's GNP, the main catalyst for the economic prosperity was the services sector. In other words, a system of dual economies was developing, in which the flourishing services sector was coexisting with less developed agriculture and industry. The 'uniquely' developed financial services provided by Lebanese and foreign banks for the region, attracted a substantial amount of petro-dollar surpluses, in addition to a remarkable flight capital that escaped the nationalisation in various 'socialist' Arab countries. Beirut, then, maintained the role of entrepôt to the Middle Eastern countries, trade wise. Through Beirut's port, most of the imported products were re-exported to the Arab countries. However, the foreign trade was always in deficit. In 1973, it amounted to LL 2,738.4 millions.<sup>241</sup> On the other hand, tourism was flourishing, and indeed, played an important role in easing the trade deficit by drawing substantial amounts of foreign exchange into the country. It also contributed 20 per cent to the country's GNP. The Merrill Lynch report considered this figure as notable, given that at that time, the international tourist industry was not as developed as it is today.<sup>242</sup>

Foreign businesses found their way to Beirut during the period preceding the war. This can be considered as a continuation of Beirut's strong business relations with Europe and the West, culminating from its historical role in trading with the surrounding region. European and US firms established their regional offices or branches serving Lebanon and the region from Beirut. Many comparative advantages like the location of Lebanon, the relative political and economic freedom it enjoyed, and the skilled-labour available for the services sector attracted these foreign businesses. The concentration of these foreign businesses in the services and trading sectors was obvious. The foreign banks list, for instance, included names like The Chase Manhattan, First National City Bank,

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<sup>239</sup> Merrill Lynch International Limited, *The Lebanese Republic*. Preliminary Offering Circular, September 1994.

<sup>240</sup> World Bank Annual Reports.

<sup>241</sup> EIU, *Quarterly economic review, Syria, Lebanon, Cyprus. Annual supplement 1975*. p. 25.

<sup>242</sup> Merrill Lynch op.cit. p.21.

the British Bank of the Middle East, and Banque Nationale de Paris Internationale.<sup>243</sup> Out of the 90 banks operating in Lebanon at the eve of the civil war 17 banks were foreign, while 26 local banks had foreign majority shareholders.<sup>244</sup> The comparative advantages mentioned above contributed to the influx of these foreign banks into Lebanon. The Lebanese system enhanced the free-market characteristic of the economy by advocating banking secrecy, freedom of exchange and freedom of capital transfer. Beirut was the perfect financial centre to serve the then accumulating petro-dollar wealth in the region.

Another factor that supported the prosperity of the country was the private remittances, which provided significant amounts of foreign exchange. The last figure of the remittances traced before the civil war was in 1970 when they amounted to \$28 million.<sup>245</sup> Inevitably, this figure would have been expected to increase on the eve of the civil war, taking into consideration the huge rise in oil prices, a development which Lebanese emigrant labour and businessmen should have benefited from.

All the conditions for economic prosperity existed in Lebanon on the eve of the civil war: an efficient financial sector; a great trading position and skills; fabulous climate and services for tourism; growing manufacturing industry (industrial exports, mainly to Saudi Arabia, Kuwait, Iraq and Syria, had been increasing rapidly from LL 87.4 million in 1967 to LL 456.6 million in 1973)<sup>246</sup>; and a moderate share of agriculture (12 per cent)<sup>247</sup> in a country inclined towards services rather than any other economic sectors. However, the civil war that flared up on April 13, 1975, brought the development process to a halt, and left the country, after sixteen years of conflict (the war ended officially in 1991), shattered economically, and in need of substantial help in carrying the burden of reconstruction.

### **3.3 Economic consequences of the civil war**

To assess the economic consequences of the civil war in Lebanon, it would be better to divide the period of the war into two phases: first, 1975 until 1982, the date of the

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<sup>243</sup> *Balance Sheets of the Banks 1974*, Association of Banks in Lebanon. Beirut. pp.5-6.

<sup>244</sup> *Balance Sheets of the Banks 1974*, (Beirut), op.cit, pp.5-6.

<sup>245</sup> EIU, *Lebanon, Annual Supplement*, 1977. p.30.

<sup>246</sup> EIU, *Lebanon, Annual Supplement* 1974. p. 19.

<sup>247</sup> Ibid.

Israeli invasion; and second, starting from 1983 until 1990. The reason behind this division is the different developments of the conflict, and consequently, the different impacts on the economy. Some factors that contributed significantly to the flare up of the civil war had a very marginal role in the second phase. Similarly, economic factors varied remarkably between the two phases.

### **3.3.1 First phase (1975-82)**

During the first phase, the armed conflict that flared up was a result of internal and external factors. As extensive discussion of this matter is beyond the focus of this paper, it will be explained in general terms as a result of the Palestinian military existence in Lebanon, and the different perceptions of this existence between the various sects of Lebanon. The Maronite Christians declared, persistently, their disapproval of the Palestinian guerrillas' existence in Lebanon, and of their activities in launching resistance attacks on northern Israel. The situation had been exacerbated by the signing of the Cairo Agreement in 1969 between the Lebanese government and the PLO.<sup>248</sup> On the other hand, the majority of Sunni Muslims, the co-religionists of the Palestinians, and the Leftists, led by the Druse Kamal Janbulat (PSP) expressed widely their sympathy and willingness to support the Palestinian resistance. As the power of the state became questionable, and the security apparatuses could not control the guerrilla's activities, the Maronites started establishing their own militias. The declared excuse was to protect themselves from the guerrillas. In 1975, tension reached its climax. After firing at a bus of Palestinians reported to be guerrillas, in a Christian area, tension spread over the country, which was then dragged into a two-year round of fighting. Clashes and skirmishes occurred constantly afterwards, and the country was thrown into anarchy and disaster. The Israeli invasion of Lebanon in June 1982 left catastrophic prints. Ironically, it was conceived by many as the climax of political and militarily conflict, and it was believed that tension would go down afterwards. This optimism was based on the PLO's departure from Beirut, to be scattered all over the Arab host countries. This wish did not materialise, and as it will be shown later, politics and economics deteriorated further, shortly afterwards.

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<sup>248</sup> Under the Cairo Agreement, the PLO was allowed to launch attacks against Israel from the Lebanese territory, and to be in charge of security in the Palestine refugees' camps.

### **3.3.1.1 Recession in economic sectors**

The fighting that flared up in April 1975 was concentrated in the central district of Beirut, the financial and commercial centre for the whole country. Many banks, offices, markets and hotels were either destroyed or looted. It brought economic activities to a halt, and imposed astronomical physical losses on businesses located in the fire zone. However, the spread of fighting throughout the country affected all economic sectors.

The agricultural sector was affected by two different conflicts in Lebanon: the civil war, and the Israeli-PLO war. As the violence caused by the civil war took place mainly in Beirut and the surrounding areas, the agricultural parts of the country were relatively out of the war zone. This excludes some occasions when clashes expanded to relatively remote areas (Zahleh in the Bekaa Valley; and Sidon in the South). The main agricultural areas in Lebanon are the Bekaa Valley, the Akkar plain in the North, and the South, in addition to some narrow coastal plains. Many of these areas were spared during the civil war. On the other hand, the Israeli attacks, culminating in the invasion of 1982, had a bad effect on agriculture. Southern parts of the country suffered Israeli raids on a daily basis. However, the two armed conflicts had some common impacts concerning agriculture. Both conflicts contributed to the migration from rural areas to the cities (mainly Beirut). The Israeli raids, starting in the late sixties, forced many Shi'a peasants to flee their villages in southern Lebanon and to become slum-dwellers around Beirut. The civil war, on the other hand, also forced new demographic changes. Christian peasants in coastal villages south of Beirut (Damour, for example) had to flee their villages to the Christian eastern parts of Beirut after being expelled by the Palestinian guerrillas. The Palestinian action was said to be retaliation for the expulsion and genocide of Palestinian refugees in Tal Za'tar camp, in the Christian suburbs of Beirut. However, without denying the role of the war in the rural-urban migration, one has to admit that this trend was exacerbated by villagers' tendency to leave to Beirut where money, they thought, was easier to earn.

In 1982, the share of agriculture in GDP was estimated at 9 per cent. Only 7 per cent of a total population of 3.3 million benefited from agriculture in 1981, compared to 19 per cent in 1970.<sup>249</sup> The share of agricultural employment of the total active population dropped to 9.2 per cent in 1981. The Israeli invasion affected agriculture badly,

however, the consequences of this invasion on agriculture will be studied later on in this section.

The industrial sector was developing significantly during the early 1970s. The years of war between 1975 and 1982 knocked out the whole process of growth in this sector. The physical capital stock of industry was vastly destroyed. In 1975-76 alone, between LL 500 million and LL 700 million direct losses were estimated, while indirect losses ranged between LL 972 million and LL 2.2 billion. Around 150 industrial establishments with total paid-up capital of LL 1 billion were destroyed, while another 321 establishments were damaged. In total, 20 per cent of the fixed capital in industry was lost.<sup>250</sup> The next rounds of violence exacerbated these figures. According to the head of Lebanese industrialists' association, by the end of 1981, the losses engendered a decline in production capacity of around 25 per cent, while the labour force involved in industry dropped by 50 per cent.<sup>251</sup> This is what Nasser Saidi referred to as losses in the human capital stock as many of the professional and skilled labour migrated, leaving production in the hands of a lesser-skilled workforce. This development, supported by the destruction of the physical capital stock, led to a reduction in productivity and forced a drop in real wages and earnings.<sup>252</sup> The Israeli invasion in 1982 worsened the situation. More factories were damaged, and the cut in means of transportation (airport, port, and roads, mainly the Beirut - Damascus highway) impinged heavily on exports.

To sum up the impact of war on the industrial sector in the first phase (1975-82), one could say that although industry did not represent a high share of the GDP of Lebanon, the substantial growth that the sector witnessed before the war was promising. The 20 per cent share in the GDP before the war could have been increased given the potential resources and markets. The physical destruction of plants and the flight of skilled and professional labour affected the productivity, while the territorial divisions and cut in outwards transportation caused segmentation in labour and goods markets, and hindered the exports' access to other countries markets.

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<sup>249</sup>Iskandar.M & Baroudi.E, op.cit, p.5.

<sup>250</sup>Ibid. p.32.

<sup>251</sup>Ibid. p.32.

<sup>252</sup>Saidi. N, Economic consequences of the war in Lebanon, papers on Lebanon, (Oxford, Centre for Lebanese Studies: 1986) p. 6.

If agriculture and industry were affected badly by the violent events of the civil war, the services sector was devastated. Lebanese financial and non-financial services were predominantly located in central Beirut and the surrounding areas. These received the biggest share of destruction once war flared up. This sector, which developed over decades of progress and contributed to 70 per cent of Lebanon's GDP in 1970<sup>253</sup>, was thrown backward within a few years.

In financial services, the vital banking sector was inevitably affected by the start of the civil war. Yet, it has to be said that after seven years (1975 until 1983), the banking sector unlike other sectors proved to be resilient. However, it was resilient in the sense that it weathered the turmoil instead of being destroyed. It provided, according to Iskandar and Baroudi, "a rare bright spot in the Lebanese economy during years of upheaval".<sup>254</sup> Indeed, the number of banks registered in Lebanon increased from 81 in 1974 to 92 in 1983.<sup>255</sup> The increase was mainly among the Lebanese banks, from 31 in 1974 to 45 in 1983. Foreign non-Arab banks increased by one bank, as did the Arab banks. Meanwhile, the number of Lebanese banks with foreign non-Arab control dropped to 15 (22 in 1974), compared to an increase in the number of Lebanese banks with Arab control to 10 (4 in 1974). However, these numbers cannot imply that all these registered banks kept operating in Lebanon during the turmoil. It was reported that many banks like Citibank and Chase Manhattan moved their headquarters from Beirut to Athens temporarily during the upheavals. These temporary headquarters soon became permanent as the hope of going back to Beirut was shattered.<sup>256</sup> The balance sheets of some of these banks indicate that they were not operating in Beirut anymore at that time. For example, the Chase Manhattan Bank assets in Beirut totalled LL 283,039,638 in 1974, while they amounted to LL 359,264,682 in 1983.<sup>257</sup> Given changes in the value of money in terms of depreciation of the Lebanese pound<sup>258</sup>, and price inflation, which stood at about 24 per cent annually in 1979-80<sup>259</sup>, it was obvious that the bank's operations in Lebanon were stalled. A comparison with another Lebanese bank supports the argument. The Banque du Liban et D'Outre-Mer had assets of LL 418,846,346 in

<sup>253</sup> Lloyds Bank Economic Report, Lebanon, 1974, p. 9.

<sup>254</sup> Iskandar.M & Baroudi.E, 1984. Op.cit, p. 209.

<sup>255</sup> Balance Sheets of the Banks, Association of Banks in Lebanon, 1983.

<sup>256</sup> EIU, Quarterly Economic Report Syria, Lebanon, Cyprus, 3rd quarter 1977, p. 15.

<sup>257</sup> Balance Sheets of the Banks, 1974, op.cit, p. 13 and 1983, p. 97.

<sup>258</sup> The US dollar was equivalent to LL 2.32 in 1974 while reached to LL 4.52 in 1983 Banque Du Liban, Annual Reports.

<sup>259</sup> Banque Du Liban, Report for the years 1979 and 1980, p. 6.



1974 which in 1983 they amounted to LL 5,624,215,474.<sup>260</sup> Thus one of the main consequences of the civil war was the flight of foreign banks, either completely or by reducing their activities to a minimum.

Although the banking sector was resilient and kept functioning, apart from some weeks when the situation was too dangerous, most of the banks were facing new problems. Iskandar and Baroudi summarised these problems as:

- "1- the accumulation of bad debt as many commercial, industrial, and other establishments sustained damages which made it difficult to repay debts.*
- 2- the dearth of safe investment outlets on the local market, as locating safe and profitable investment in the private sector was becoming difficult. The alternative was to subscribe to treasury bills.*
- 3- the slow-down in import-export activity which had serious effect on commercial banks that considered the issuing of letters of credits and guarantee as a major and highly profitable aspect of their operations.*
- 4- the excessive competition as the number of banks was quite large compared to the size of the market. Before the war, most banks were able to acquire a share of the growing market. The slow-down in economic activities forced banks towards a stiff competition in order to maintain their share. Some of them gave un-guaranteed loans, others gave higher interest rate than treasury bills by 3-4 per cent.*
- 5- the rise in operating costs, as many banks opened new branches before the war. These branches added significant operating costs without providing the return in increased activity and clients, and hence growth revenue due to the slow-down in economic activities."*<sup>261</sup>

Despite these problems, the banking sector survived. The total assets of the commercial banks, which amounted to LL 12,319 million in 1974, rose to LL 37,197 million in 1980. This included a rise in foreign assets from LL 3,980 million to LL 13,401 million respectively. Credits to the private sector also increased from LL 5,733 million to LL 16,166 million in the same period. Indeed, the central bank had to impose restrictions on credits in Lebanese pounds, which rose by 17 and 25 per cent in 1977 and 1978.<sup>262</sup> One might attribute this phenomenon to what was mentioned above about the stiff competition between a large number of banks in a relatively stagnant market. But,

<sup>260</sup> Balance sheets of the banks, 1974. p. 64 and 1983. p. 15.

<sup>261</sup> Iskandar.M & Baroudi. I, op.cit. pp. 207-209.

<sup>262</sup> Banque du Liban, Report for the years 1979 and 1980. pp. 20-25.

questions do arise as to how the banking sector did survive. The increase in assets answers this question. The war affected the economic activities badly but the freedom of exchange and transfer of money was not touched. Money continued to flow into the country from different resources. In addition to the remittances from expatriates, Lebanese and Palestinians (remittances amounted to US\$ 8.1 billion in 1982, while PLO annual spending reached US\$ 900 million)<sup>263</sup>, in the Gulf countries and elsewhere, one should remember the inflows of unofficial aid from the surrounding Arab regimes to the various factions involved in the civil war.<sup>264</sup> Almost every faction had an outside sponsor, transferring money which was then circulated in the economy. Moreover, the resilient Lebanese mentality motivated them to reject the standstill situation and use the breaks between rounds of violence to repair damages and conduct business. This helped in sustaining the economy, and consequently the banking sector, over that period.

In insurance, the rapid growth that had characterised the sector in the early seventies came to a halt after the beginning of the civil war. The gross premiums in all branches of insurance dropped sharply in 1975-1976 to just LL 26 million in 1976. Before the war, the net premiums of only non-life branches averaged at LL 56.9 million annually between 1972-1974. The non-life branches net premiums picked up again in 1977 to LL 44.5 million but were still 44 per cent below 1974 level. In all cases, the leading companies, mainly Lebanese, were getting the bulk of the premiums in the non-life branches. In 1972-1974, their share was 46 per cent, while in 1977 it increased to 62.4 per cent. That was largely due to the withdrawal of 23 small foreign companies in 1975 and 1976.<sup>265</sup> Foreign insurance companies' share in the non-life branches dropped sharply from 61.7 per cent in 1972 to 24.6 per cent in 1979. Lebanese companies were strengthening their control over the insurance market. Their share increased from 71 per cent in 1980 to 76.8 per cent in 1982.<sup>266</sup> However, in the life insurance branches, foreign companies, though very few (6 out of 25 companies in 1982), maintained a high share of the market. Their share of net premiums amounted to 64 per cent over the 1979-1982 period. This is to be attributed largely to the main position of American Life

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<sup>263</sup> Labaki, B., *Lebanese Emigration During the Civil war (1975-89)*, an article in Hourani, A. & Shehadi, N. (ed) *The Lebanese in the world: A century of emigration* (Oxford, Centre for Lebanese Studies: 1992), p.607.

<sup>264</sup> Makdissi, S., *Political Conflict and Economic Performance in Lebanon, 1975-86*, Occasional Papers Series (Centre for Contemporary Arab Studies, Georgetown University, September 1987) p.6.

<sup>265</sup> Ibid. p.251.

<sup>266</sup> Ibid. pp:253-254.

Insurance Company in this branch. The share of this company alone averaged 55 per cent of total net life branch premiums between 1980 and 1982.<sup>267</sup>

Generally, the war benefited the Lebanese insurance companies in one aspect only: the flight of many foreign competing companies. Though the total premiums fell at some stages, the bulk was now going to the Lebanese leading companies.

Expectations for tourism were high on the eve of the civil war. The sector's share in GDP had increased from 10 per cent in 1964 to 19 per cent in 1975.<sup>268</sup> There were 2.19 million visitors to Lebanon in the first quarter of 1974, representing a 50 per cent increase over 1973. Indeed, the first quarter of the year witnessed 10.5 per cent increase over the same period of 1974. However, the fighting that flared up in the middle of the year brought the number of visitors from 537 thousands in the first three months down to almost zero.<sup>269</sup> Estimated income calculated from the amount of bed-nights in Beirut declined from LL 967 million in 1974 to LL 670 million in 1975 and zero in 1976. It recovered to 200 million in 1977,<sup>270</sup> a figure that was still minimal. Many hotels were completely destroyed or looted. However, the Merrill Lynch report suggested that the large number of Lebanese expatriates, many of whom continued to visit the country on regular basis over summer allowed the tourism sector to survive.<sup>271</sup> Yet, the impact of those visitors on the hotel industry can be disputed because these Lebanese expatriates would have their family residences and would not need to stay in hotels. The number of hotels operating in Lebanon in fact dropped sharply.

Over all, the country lost a crucial source of revenue with the destruction of the tourism industry. The losses were not confined to the physical capital stock. It was also about losing confidence in Lebanon as a good destination for tourists, mainly for Arabs. Indeed, many neighbouring countries benefited from the destruction of Lebanon's tourism industry. Huge numbers of Arab tourists redirected their destinations to Egypt, Jordan and other surrounding countries that replaced Lebanon.

As for transport and transit trade, the civil war damaged this sector badly. The roads were in many places not safe to use due to the partition of the regions. The port was

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<sup>267</sup> *Ibid.* p. 255.

<sup>268</sup> *Lloyds Bank Country Report, Lebanon*, 1979, p.16.

<sup>269</sup> EIU, *OER, Annual Supplement* 1977, p. 29.

<sup>270</sup> *Lloyds Bank Country Report, Lebanon*, 1979 p. 17.

<sup>271</sup> Merrill Lynch Lebanon Report, (1994) p. 21.

closed for a long time as it was on the 'green line', while many of the goods stored were looted. Traffic had to be diverted to other Lebanese ports at Tripoli, Jounieh and Sidon, all of which had minimal capacity compared to Beirut port. The airport closed during the rounds of violence. In 1978 it handled 1.4 million passengers, which corresponds to only half the number of passengers in 1974. Middle East Airlines (MEA), the Lebanese carrier, suffered substantial losses. Many of its carriers were leased or operated from different airports during that period. Trans Mediterranean Airways (TMA), a Lebanese cargo carrier moved its headquarters to Paris.

### **3.3.1.2 The impact of war on foreign companies**

Due to its position as the financial centre and the entrepôt to the Middle East, Beirut had attracted the regional headquarters of many foreign companies. They ranged from banks and insurance companies to airlines and manufacturers. Beirut provided, in addition to freedom of exchange and tax exemptions, a friendly environment for Westerners to live in. The high rate of spoken English and French helped the Americans and Europeans to settle and conduct business in Beirut.

The war in 1975 changed the picture. Beirut was no longer safe for foreigners. The random shelling and sniping did not distinguish between natives and foreigners. Besides, the market was stagnant and no business could be conducted. Foreign corporations started fleeing Beirut, initially on a temporary basis, though eventually all the temporary headquarters became permanent after the hopes for Beirut recovering and returning to its previous status were unfulfilled. The first foreign companies reported to flee the country were Bechtel, Goodyear, Firestone, Morgan Guaranty, Chase Manhattan Bank, First National City Bank, McDonnell-Douglas and Sheraton. Of the 113 Japanese companies having offices in Beirut, three-quarters partly or wholly evacuated their staff and family members.<sup>272</sup> Later in the same year, other big companies who had been established in Beirut for years decided to leave. Among them were the American Mobil Oil and ESSO Standard (Near East), and Shell Oil of the UK. Pan-American airlines and American Life Insurance Company were to follow suit.<sup>273</sup> Of the cities that replaced Beirut as the centre for foreign corporations' operations were Athens, Cairo and Amman. Some went to Tehran, others to Bahrain due to the financial

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<sup>272</sup>EIU, QER, 1976, no.1, (1976) p. 9.

incentives provided.<sup>274</sup> Indeed, most of the US companies chose mainly Athens, although some moved to Cairo, while European and Japanese moved to Tehran, Dubai and few to Cairo and Amman. Some of these cities, like Amman, were already trying to attract foreign interest and lure it away from Beirut.<sup>275</sup> Despite all the government's attempts to bring the foreign firms back in 1977, when the security situation was relatively better, the response was minimal. In January 1977, the government passed a law under which it would insure investments in Lebanon against the hazards of civil war, revolution, dissension and acts of violence. A banking free zone law, which exempted non-residents from foreign guarantee tax and from reserve requirements, came into effect on April 1<sup>st</sup> of the same year. However, foreign firms were no longer interested.<sup>276</sup>

### **3.3.2 The second phase of the civil war (1983-1990)**

Lebanon's economy witnessed several changes after 1983. It was affected by the political and economic development that occurred over that period on both local and regional forums. Surprisingly, this period started with some optimistic expectations after the Israeli invasion and the restoration of a new government under a new president. However, this optimism did not stay for long. Pessimism was the overall picture again. Inevitably, the economy was affected by the worsened situation. However, one of the main factors of deterioration of the economy was the government's involvement in the conflict. Since 1975, the government had been to a great extent remote from the dispute. As the army had not been involved in the armed conflict, no cost of the war had been carried by the government. After 1983, the state became a party in the war and the army was fighting the Leftists in Western Beirut and the mountain. This led to a division of the army between Muslims and Christians. The government had already spent a lot of money on rebuilding the Lebanese Army. Military expenditure doubled from its pre-1982 level (26.3 per cent of the budget in 1979).<sup>277</sup> The involvement in the war meant

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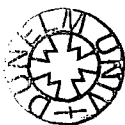
<sup>273</sup> EIU, QER no.4 (1976) p. 16.

<sup>274</sup> EIU, QER, no.3, (1977) p. 15.

<sup>275</sup> EIU, QER, no.2, (1976) p. 13.

<sup>276</sup> EIU, QER, no.2 (1977) p. 17.

<sup>277</sup> Elkhazen. F, *The Lebanese Economy After a Decade of Tormoil, 1975-1985*. In *American-Arab Affairs*. (Spring 1986) p.80; Saba. E, *A New Role for Lebanon*. Interview in the *Arab Banker, Journal of Arab Bankers Association* (London: Volume V, no. 4, July/August 1985) p.7.



drawing government resources to fund the conflict, a development that did not exist in the previous period because the war was funded 'privately'.

Economic activities were reduced due to the complete separation of the regions which, consequently, meant isolation of the markets. Government revenues declined, as the government was not able to collect taxes and customs at a time when most of the ports were under the militias' control. Externally, the recession in the oil-exporting countries caused a decline in remittances from Lebanese expatriates, an income which had played a major role in sustaining the economy over the previous period. Finally, the PLO expulsion from Beirut ended the Palestinian 'mini-state' in Lebanon. Thus, the Palestinian economy in Lebanon was destroyed, and Lebanon was deprived of regular foreign currency inflows.<sup>278</sup> The reduction in government revenues and the excessive spending led to a large budget deficit (LL 10 billion in 1984, up from LL 7 billion in 1982). The government resorted to borrowing in order to cover the deficit, and national debt reached LL 30.4 billion in 1984, up by LL 18 million from the 1982 level.<sup>279</sup> Unlike other developing countries, the Lebanese government did not seek to finance its deficit through foreign aid. It relied instead on the internal financial sector. Treasury bills and commercial banks loans were the main source. That is why foreign debt was still minimal until the 1990s (US\$ 290 million in 1992).<sup>280</sup>

The developments on the political and security sides equally affected the various economic sectors. In the following section, a brief coverage of the impact on economic sectors in the period (1983-1990) is provided. In the agricultural sector, the consequences of the Israeli invasion in 1982 were realised from 1983 onwards. When the Israeli troops were re-deployed in the south, this region became a separate territory cut off from the rest of the country. Agricultural products of the South (citrus fruits, vegetables, tobacco...etc.) were denied access to the other Lebanese territories due to severe restrictions imposed by the Israelis. This meant also a decline in exports as the citrus fruits exports to the Arab countries came mainly from the south. Israel, moreover, started dumping loads of cheaper agricultural products in the Lebanese market (at least in the occupied parts). This represented stiff competition for the Lebanese products. It

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<sup>278</sup> Elkhazen, F, *The Lebanese Economy After a Decade of Tormoil, 1975-1985*. op.cit.

Kubursi, A, *The War Economy of Lebanon: The Confessional Links*. (Unpublished paper. Archives of the Centre for Lebanese Studies, Oxford) p.5.,

<sup>279</sup> Elkhazen, F, (1986) op.cit. p.80.

<sup>280</sup> Merrill Lynch report, op.cit. p.28.

also motivated some Arab regimes to impose restrictions on Lebanese exports fearing that they might include Israeli products. Agriculture also suffered from an Israeli policy of destruction. The Israeli army tended to destroy wide acres of citrus fruit fields in the South, on the sides of the main roads, claiming it was a measure to curb resistance attacks. Resistance guerrillas used to ambush Israeli patrols in the fields, it was said. This caused huge losses for farmers in the South. After 1985, Israeli troops withdrew from the South but a narrow strip was kept as a security zone. The subsequent years were better as the security status improved in the rural areas. Moreover, the decline in the Lebanese pound rate gave the local agricultural products a more competitive position in the internal market as well as in the neighbouring Arab countries. However, agriculture still faced many problems such as the high cost of transportation and the lack of planning.<sup>281</sup>

In industry, the pre-1982 situation allowed factories to operate during periods of calm, or in areas safe from shelling. The rounds of violence that divided Beirut again into two Eastern and Western parts, after 1983, affected industry badly as many of the factories were in the 'green line' area. In a survey prepared by the UN office, it was declared that 800 factories were destroyed between 1985-1991. Out of them, 600 factories were destroyed in the war between the army under General Aoun's command and the pro-Syrian government in 1989-1990. This led to a decrease in industrial exports, which was an important source of foreign currency.<sup>282</sup> Industrial exports deteriorated in 1984 to US\$ 145 million, compared to a US\$ 524 million in 1981 and US\$ 254 million in 1982. However, the period 1987-1989 witnessed some improvement. It reached to US\$ 19 million monthly in 1989 according to the Chamber of Commerce and Industry<sup>283</sup>. The reasons for the fluctuation in the amount of the industrial exports are, on one side, the deterioration in production due to the closure of many establishments; decline in investments in industry; a decrease in credits to industrial establishments; and backwardness of available machinery which was not updated. Moreover, at the very beginning of this period, Lebanese industrial exports faced the closure of Arab markets, same as agricultural exports, as Arab countries feared the smuggling of Israeli

<sup>281</sup><sup>281</sup> *Banque du Liban, "a-taqrir a-sanawi" Annual Report, (1986) p.8.*

<sup>282</sup> Haidar, M, *Asbab hobout al-lira a-lubnaniyah 1975-1991: Dirassah min al-manzour al-iqtisadi wal-mali. Reasons for the Collapse of the Lebanese Pound in 1975-1991: An Economic and Fiscal Perspective.* (London: Archives of the Centre of Lebanese Studies, 1993) p.14.

<sup>283</sup> *Ibid.* p.15.

products<sup>284</sup>. On the other side, the increase in production and exports (in the second half of the 1980s) could be largely attributed to the depreciation of the Lebanese pound. The low rate of the Lebanese Pound gave Lebanese products competitive position in both internal and external markets, as the cost of production became less, while prices of imported goods jumped above consumer's purchase power<sup>285</sup>.

The tertiary sector was hit with further deterioration after 1983. The hopes that rose in that year with the reconstruction plans soon collapsed. Many roads were rehabilitated and light poles were seen again in the streets of Beirut. The downtown district was cleared of barricades to be rebuilt. However, this work soon stopped, and the reconstruction process was hindered by the renewal of violence later during that year. Thus, the services sector that had a chance to pick up had a down turn again. Beirut's port and airport witnessed long periods of closure, a development accompanied by the closure of the Beirut-Damascus highway, which brought transit trade to a halt.

In the financial sector, banking activities declined in that period as well. The deterioration in economic activities after 1983 affected the banking sector. This was due to the flight of capital; the depreciation of the Lebanese pound; political instability and economic stagnation.<sup>286</sup> The real output of banking dropped sharply between 1982-1987. The assets decreased by 24 per cent in real terms, annually. Real non-bank deposits followed suit by 25 per cent and real credits by 34 per cent. The number of banks dropped to 83 while branches increased to 703 by the end of 1987. This was due to the partition of regions, and a measure taken by banks since 1975 to facilitate banking operations. Problems of liquidity became common and some banks were unable to avoid bankruptcy. Many banks established offices abroad in the Arab countries and Europe (mainly France and Cyprus). This policy was considered defensive rather than expansionist as these banks followed their customers who fled the country, partly to avoid huge withdrawals. However, those offices proved not to be profitable as the original offices in Lebanon.<sup>287</sup> Therefore, the sector that was resilient during the first years of the civil war and proved to be the only motive for optimism seemed to be retreating against the fiscal crisis, and the stagnation in the economy.

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<sup>284</sup> Ibid. p.15.

<sup>285</sup> *Banque du Liban Annual Report*, (1986) p.80.

<sup>286</sup> Osseiran.F, *Banking performance in Lebanon 1982-1987*. Association de Banques du Liban, Rapport du Conseil (1989-1990) p.189.

<sup>287</sup> Osseiran.F, *Banking performance in Lebanon 1982-1987*, op.cit, pp.170-178.



### **3.3.2.1 Summary: the impact of the civil war**

The civil war changed the features of Lebanon's economy drastically. It caused a deterioration in GDP after steady growth; a budget deficit and huge public debt; sharp depreciation of the Lebanese pound; almost complete destruction of the productive sectors; and a brain drain after the flight of most professionals and skilled labour. During the years of war 990,000 Lebanese left their country.<sup>288</sup> The reasons that exacerbated this economic deterioration could be found in the decline in the output of all productive sectors; the lack of capital, mainly after 1982 (both expatriates' remittances and foreign aid); and huge public debt. Indeed, the huge public debt was a result of the reckless fiscal policy applied by the government to cover its budget deficit, which mounted up due to the lack of governmental revenues usurped by militias. The central bank lost huge amounts of foreign currency reserves due to the reckless monetary policy trying to maintain an artificial rate of the Lebanese pound, which eventually did not work and ended up in a massive deterioration of the rate of the currency.

Having said that, it would be irrelevant to talk about foreign firms operating in Lebanon. During the 1980s, not only foreign firms disappeared from Lebanon, but also foreign people vanished. The bombing of the American and French embassies in 1983, forced many of the remaining foreigners to leave the country. The abduction of foreigners in the later years was enough to push all of them out of the country.

### **3.4 Post-civil war period: recovery and reconstruction**

The civil war drew to its end in 1990. The catalyst for this end was the signing of the Ta'if Agreement by the members of Lebanese parliament in October 1989. This agreement was to pave the way for national reconciliation and an end to the Lebanese conflict. However, there was a set of developments that formed a prelude to the Ta'if Agreement. By September 1988, the term of the outgoing President Amin Gemayel

came to an end with no elected successor. The Lebanese parliament was not able to convene to elect a new president. The 'constitutional void' resulted in handing the reins of power to the commander of the army, General Michel Aoun, who formed a martial cabinet. The rejection of this *fait accompli* by the then pro-Syrian cabinet meant that the country was run by two separate governments. A few months later, General Aoun declared war on Syria, aiming to end the Syrian military presence in Lebanon. This was to mark the start of another round of violence leaving in its wake vast human and physical losses.

### **3.4.1 The Ta'if Agreement**

Mediation attempts that were undertaken by the US and the Arab League culminated eventually in flying the surviving members of parliament, in November 1989, to the town of Ta'if in Saudi Arabia. There, they agreed on a national reconciliation by signing what has been known since then as the Ta'if Agreement. This agreement stipulated the amendment of the constitution to establish some kind of balance between the sectarian factions of Lebanon. Back in Lebanon, the parliament convened on 5 November 1989 and elected a new president, Rene Moawad, who was to be assassinated weeks later. A successor was elected promptly. The new president was Elias Hrawi, the MP of Zahleh. Aoun rejected the agreement and the subsequent presidential elections as being Syrian-orchestrated. The stalemate in the Lebanese situation was to stay until the Syrian/'Ta'if-Lebanon' alliance stormed Aoun's enclaves. He in turn fled to the French Embassy and asked his Lebanese Army troops to surrender to the Ta'if government. His agreed departure to Paris was to signal the end of the civil war of Lebanon.

The Ta'if Agreement established important changes in the factional system of Lebanon. The Muslims' outcry about their maltreatment in the Lebanese constitution resulting from their under-representation in the parliament and the excessive authorities of the Maronite president was to have a response. The signing of the national reconciliation covenant in Ta'if led to the seventh amendment of the 1926 constitution that had been drafted by the French authorities, on 21 September 1990. Juhha considered the Ta'if amendments to be the most important after the fourth amendment of 1943, which

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<sup>288</sup> Labaki.B, in Hourani.A & Shehadi.N, (1992) op.cit, p.609.

abolished the points referring to the French mandate authorities.<sup>289</sup> Thirty-one points in the constitution were amended to accommodate the new changes. The most crucial of these changes were: shifting the executive authorities from the Maronite president, who was supposed to be assisted by ministers, to the Council of Ministers headed by the Sunni PM. The President became "the Head of the State and the symbol of its unity" while the Council became the authority that controlled the armed forces and all executive authorities, which were previously mostly in the President's hands.<sup>290</sup> The Council of Ministers was freed, in a way, from the President's upper hand through his right to dismiss the PM or the Council. After Ta'if, only a parliamentary vote could dismiss the PM.<sup>291</sup> The previous division of parliamentary seats between Christians and Muslims, which favoured the Christians, was changed as well. The formal ratio of 6:5 seats was to become 1:1 between Muslims and Christians. However, this provision was meant to be temporary until a new, non-sectarian, electoral system was established.<sup>292</sup> The Shi'a share was improved by extending the tenure of the Speaker of the Parliament to four years instead of one. The office also received a vital boost by obliging the president to consult the Speaker after conducting compulsory parliamentary consultations before naming a new PM.<sup>293</sup> More importantly, the amended point 95 stipulated that the parliament be elected on an equal basis between Christians and Muslims and should take suitable measures to abolish sectarianism. This was to replace the provision of 'just' distribution of public sector posts amongst factional groups.<sup>294</sup>

The Ta'if agreement has overhauled the Lebanese ruling system, which was described by Paul Salem as "presidential" due to the excessive authorities having been attached to the president's office.<sup>295</sup> However, he considered that the coalitional and confessional aspects of the system remained intact. It stayed a matter of power-sharing based on the factional divisions of the Lebanese people and the representation of each sectarian group. Hudson commented that although the Ta'if agreement restored a "temporary"

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<sup>289</sup> Juhha, S, "a-dustur a-lubnani, tarikhu, ta'adilatuh, nassuh al-hali 1926-1991" (*The Lebanese Constitution: Its History, Amendments, Current Text 1926-91*). (Beirut, Dar el-'elm lil-malayin: 1991) p.:27.

<sup>290</sup> Juhha, S, (1991) op.cit.

<sup>291</sup> Taif; *The Changing Rules of the Political Game*. In *Lebanon 1997-8*. Oxford Business Group. Op.cit, p.16.

<sup>292</sup> Juhha, S. (1991) op.cit, p. 28.

<sup>293</sup> Ibid. p. 65.

<sup>294</sup> Ibid. p. 95.

<sup>295</sup> Salem, P, *Framing Post-war Lebanon: Perspectives on the Constitution and the Structure of Power*. *Mediterranean Politics*. (3) no.1 Summer 1998. p.14.

confessional order, it was a "fine-tuned one to accommodate new realities".<sup>296</sup> He added that the agreement had a clear commitment to dismantling confessionalism. Whether these commitments were met in practice is another matter indeed. As a matter of fact, not a single point in the constitution stipulates the religion of the president, the PM or the speaker. It has been always a tradition, rather than a constitutional rule. Apart from constitutional changes, the Ta'if Agreement provisioned other reforms. Amongst these were the disarming of militias; the formation of a Social and Economic Council to participate in economic and social policies; the implementation of widespread administrative decentralisation and the revival of municipal government; the redeployment of the Syrian 30,000-troops to the Bekaa Valley two years after establishing the first post-war government; and establishing special relations with Syria. Some of these provisions are yet to be implemented.

#### **3.4.2 The new government; militias disarmed**

It seems that the prerequisite to disarm militias and establish government's authority over the country was to establish a government with the warlords being its pillars. This is how we could describe the first post-war government established by Omar Karami in December 1990. Karami's government, supported by the Syrians, managed to disarm the Lebanese militias and extend the Lebanese Army's authority to the regions. Only Hizbollah was exempted because of its engagement in resistance against Israel. Even Palestinians were confined to their camps after stretching out into places like Sidon. Heavy weaponry was to be handed to the Lebanese Army.

However, Karami's government had to go in May 1992 under heavy public pressure due to its failure to address economic problems. A new government was established by Rashid Sulh, not expected to solve the problem but to prepare the country for the first parliamentary elections since 1972. Elections took place despite huge Christian opposition, which saw the elections as being Syrian orchestrated. The prevailing Christian boycott of the summer elections resulted in the emergence of a new type of parliament characterised by an absence of real Christian representation. In addition, new strata of representatives appeared in the parliament composed mainly of pro-Syrian warlords and their followers, while many traditional notable families were relegated.

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<sup>296</sup> Hudson. M.C, Lebanon After Ta'if: Another Reform Opportunity Lost? *Arab Studies Quarterly*. (21)

These elections ended by bringing Nabih Berri, the leader of Shia Amal Movement and strongest ally of Syria, to the helm of the parliament. Soon after, the majority of the new MPs were to suggest the name of Rafiq Hariri for the office of PM. He was the man to start the reconstruction process.

### 3.4.3 The economic side of the story

The 'War of Liberation' that was waged by General Aoun against the Syrians exacerbated the dire economic situation of the country. The currency had already depreciated immensely against the US dollar and the government had very limited revenues due to the absence of its authority. That meant resorting to borrowing to fund expenditure. The Lebanese exports that had flourished in the mid-eighties, due to the depreciation of the Lebanese Pound, were reduced by 23 per cent in 1988 and 21 per cent in 1989. Meanwhile, the IMF estimated the decrease in output at 15 per cent and 10 per cent in 1989 and 1990 respectively.<sup>297</sup> A'yash noted that despite a nominal increase of 114 per cent in the value of government revenues in 1989, this was enough to fund only 9 per cent of the expenditure. Thus, the budget deficit/expenditure reached 90 per cent while it was estimated at 20 per cent of GNP. Domestic public debt also increased by 88 per cent.<sup>298</sup>

The positive impact of the end of the civil war and the establishment of a new government on the Lebanese economy is undeniable. Capital inflows from Arab and Lebanese expatriates' sources instigated a surplus in the balance of payments reaching US\$ 1074 m in 1991. The same indicator had suffered a deficit of US\$ 309m and US\$ 431 m in 1989 and 1990 respectively.<sup>299</sup> GDP grew also by 40 per cent.<sup>300</sup> On the monetary level, inflation decreased from 69 per cent in 1990 to 51 per cent in 1991.<sup>301</sup> The exchange rate of the Lebanese pound showed a relative stability by depreciating by only 4.2 per cent against the US dollar.<sup>302</sup> Dollarisation that reached 77.2 per cent of

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no.1, Winter 1999. p.28.

<sup>297</sup> Al-'Ayash. G, op.cit, pp.65-66.

<sup>298</sup> Ibid.

<sup>299</sup> Banque du Liban. Annual Report 1990-91-92 (Arabic version) p.17.

<sup>300</sup> Ibid. & Manala. N, Assiyassah al-'imariyah fi lubnan: min khitat a-nohoud ila al-barnamiji al-inma'i (Reconstruction Policy in Lebanon: From the Recovery Plan to the Development Programme) (Beirut: al-markaz al-'arabi lil-ma'aloumat – Assafir, 1995).

<sup>301</sup> Figures cited from Monetary Developments: Running a Tight Regime in Lebanon 1997-8. Op.cit, p.48.

<sup>302</sup> Ibid.

bank deposits in September 1990 dropped to 73.6 by the end of the same year, and reached 68.3 per cent by the end of 1991.<sup>303</sup> The still high figures of dollarisation reflected the rather doubtful position of the Lebanese currency despite the relative stability of its rate. Interest rates on T-bills, which reached 24.98 per cent in real terms in 1990, had ascended to 28.18 per cent in March 1991 to descend afterwards to the rate of 19.47 per cent by the end of 1991.<sup>304</sup> This still high rate of interest affected the rate of dollarisation in deposits. Interest rates on borrowing in Lebanese Pounds had gone up following the T-bills rate, and also due to the volatility of its value. The other option was to borrow in dollars at a lower rate. On the fiscal level, the extending of government's authority to the regions enabled it to lay hands on substantial sources of revenues. Special reference can be made here to the illegally operated ports that had deprived the government of its traditional major source of revenues, the custom duties. Government revenues thus quadrupled from LL 126.4 bn in 1990 to LL 522.2 bn by the end of 1991 (over 300 per cent). In 1992, this figure had almost doubled to LL 1,030.9 bn.<sup>305</sup> Meanwhile, the deficit/expenditure rate was reduced to 56<sup>306</sup> per cent in 1991. In 1992 it was 58 per cent.<sup>307</sup> This can be considered a big achievement when compared to the astronomical deficit figures of 1989 and 1990 when it reached 91 and 83 per cent respectively. However, the government did not seem to have a clear fiscal policy in order to reduce the high level of budget deficit and public debt. On the contrary, the government resorted to borrowing from the domestic market at high interest rates to cover its rising expenditure. Over 37 per cent of the government's expenditure went to fund public sector salaries, which amounted to LL 370 bn in 1991, while domestic-debt service was over 21.5 per cent. Investment figures surged sharply from LL 33.1 bn in 1990 to LL 161 bn in the following year. The latter expenditure can be justified as the government had to start a development process to install some essential services that were completely destroyed. These figures were to double in 1992, in addition to other expenditure. The fiscal policy proved to be faulty when the government decided to increase public sector salaries by 120 per cent, adjusting them to the changes in the value of the Lebanese Pound. Enough funds were not secured for this swelling cost, particularly as other expenditures went up. Consequently, salaries reached LL 660.1 bn

<sup>303</sup> *Monetary Developments: Running a Tight Regime in Lebanon 1997-8*. Op.cit, p.40.

<sup>304</sup> Ibid. p.72.

<sup>305</sup> Ibid. p. 61.

<sup>306</sup> The statistics of the Central Bank pointed out that revenues were boosted by a Saudi donation of LL 65.6 bn.

(30.26 per cent of expenditure and 64.03 per cent of revenues). Investment doubled to LL 313.9 bn (14.39 per cent of expenditure). Obviously, more borrowing was needed to cover the deficit, thus internal debt service doubled, snatching LL 453.9 bn of the expenditure and representing 20.81 per cent. However, extra expenditure of LL 545.8 bn went into miscellaneous current expenditure. That was because of the need to inject life into governmental departments that had been 'paralysed' for long periods of time. This amounted for over 25 per cent of expenditure.<sup>308</sup>

The 1992 government budget rendered the economic situation very precarious. The exchange market was affected as the demand for dollars hiked parallel with a huge sale of LL T-bills. Capital flight was recorded as well, particularly from capital that had flowed into Lebanon the year before.<sup>309</sup> The rate of the Lebanese currency plummeted against the US dollar from LL 879 by the end of 1991 to LL 1,730.5 in May 1992 when the Karami government was publicly forced to step down. However, under the Sulh government, the monetary situation did not improve. On the contrary, the deterioration of the Lebanese Pound continued, reaching a record high of LL 2,825 in September 1992 during the first parliamentary elections.<sup>310</sup> Improvements were not to happen until the end of the elections and consequent arrival of Hariri to the PM office.

#### **3.4.3.1 The flow of capital**

The capital flow that is meant here is both private investment and aid. The first was mostly to come from Lebanese expatriates while the second was expected from Arab and other friendly donors. As for the expatriate funds, despite a remarkable flow, it was below the Lebanese government's expectations. According to IMF statistics, between US\$ 10 bn and US\$ 15 bn were still held abroad by Lebanese expatriates in 1991. Yet, the majority of the significant influx of capital in 1991 went into real estate investments instead of being directed into productive investments.<sup>311</sup>

After the end of the civil war and the restoration of the government's authority, the process of reconstruction should have started. However, rebuilding needed money while

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<sup>307</sup> Al-'Ayash. G, op.cit, p.68.

<sup>308</sup> All figures are derived from Banque du Liban statistics in the Annual Report for 1990-91-92.

<sup>309</sup> Al-'Ayash. G, op.cit, p.71.

<sup>310</sup> Figures of exchange rate are from Banque du Liban statistics. Annual Report 1990-91-92, p: 50.

<sup>311</sup> The Middle East and North Africa. (Europa publications Limited, 1997) p.707.

revenues were scarce. The only way to jump-start the reconstruction was if foreign aid was channeled into the country. The Lebanese bet heavily on aid anticipated to come from abroad. Promises of Arab aid were made at the Arab leaders' summit in Baghdad in May 1990. They agreed to set up an International Fund for Assisting Lebanon. The Iraqi invasion of Kuwait and its consequent Gulf War II caused the shelving of the idea.<sup>312</sup> The Lebanese Minister of Exterior Fares Bouez announced in October 1991 that the fund was to be established with US\$ 2 bn, US\$ 500-\$ 600 m of which would come from the Gulf States and a further US\$ 500m from Japan, France, Germany, and Italy. Nothing came through, however. The World Bank took another initiative in December 1991, by sponsoring a meeting for potential donors to Lebanon in Paris. PM Karami requested US\$ 4,450 m for urgent projects over the subsequent three years. Only US\$ 700 m was pledged in response, most of which had been promised earlier through bilateral agreements.<sup>313</sup> The Kuwait Fund for Arab Economic Development (KFAED) agreed also to give a US\$ 36 m loan for power projects, while the Arab Fund for Economic and Social Development (AFESD) granted US\$ 73 m, also for power schemes. Italy emerged in February 1992 as the biggest Western contributor to Lebanon's reconstruction by earmarking US\$ 460 m in loans and grants for various infrastructure projects. However, it was not clear whether all these pledges were included in the US\$ 700 m promised earlier in Paris or not.<sup>314</sup> What is sure is that very little promised aid was received.

#### **3.4.4 The reconstruction process: Hariri's vision of reconstruction and economic development 'Horizon 2000'**

The immediate impact of Hariri's appointment as the new Prime minister was seen in the rapid monetary recovery in the exchange rate. After the sharp deterioration of the Lebanese Pound, which reached LL 2,825 for a US\$ 1 in 1992, the end of the same year witnessed a significant evolution of its value reaching LL 1,800 for a dollar. Hariri's arrival was seen as sign to commence the reconstruction process effectively.

Being one of the architects of the Ta'if Agreement, Hariri committed himself to its application. Moreover, as the Syrian consensus is essential in Lebanese internal politics,

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<sup>312</sup> *The Middle East and North Africa*. (Europa publications Limited, 1997), op.cit, p.707.

<sup>313</sup> Ibid.

<sup>314</sup> Ibid.



he had to pledge to strengthen relations between the two countries. These two pledges were amongst many Hariri declared in his Cabinet address to the parliament to win its vote of confidence.<sup>315</sup> He announced the start of the repatriation of all displaced Lebanese and stressed the need for administrative reforms for economic development. Health care and education were to be improved, and modern infrastructure was to be built. "Without advanced telecommunications, Lebanon cannot hope to restore its former role as a regional business centre", he stressed.<sup>316</sup> Hariri considered construction and development as two inter-linked aspects of the socio-economic problem that was facing Lebanon. For that he stressed three principles:

- The consolidation of the free economic system, through which the government will act to solve our economic problems as part of the process of rebuilding the state on sound basis. He emphasised that the state will set the example for citizens by rationalising expenditure and desisting from futile expenses.
- Problems that are facing construction and development shall be identified and solved accurately and scientifically to secure serious achievements.
- Speeding up reconstruction absolutely does not mean neglecting the balanced and long-term development objectives. Therefore, he added, the government will draw up a socio-economic concept based on the free economic system.<sup>317</sup>

Concerning the fiscal policy of his government, Hariri stressed that some of the most prominent priorities of his government were combating inflation and monopolies, stabilising the currency's rate of exchange, and restoring confidence in it. He ensured that the government's budget deficit would be eliminated through controlled expenditure and increased revenues. The latter was to be achieved by improving collection of taxes and levy of all custom duties. He promised to develop the taxation system on the basis of social and economic criteria. This would encourage Lebanese and Arab investments, and speed up the development cycle, he asserted.<sup>318</sup>

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<sup>315</sup> SWB, Summary of World Broadcast. "Hariri's Speech in the Parliament". BBC. 11, November 1992. p.2.

<sup>316</sup> SWB, Summary of World Broadcast. "Hariri's Speech in the Parliament". op.cit.

<sup>317</sup> Ibid.

<sup>318</sup> Ibid.

The reconstruction plan, 'Horizon 2000', was prepared by the Council for Development and Reconstruction (CDR), an agent that had been established by the government back in 1977 to be in charge of reconstruction. Even before the arrival of Hariri to power, his influence in the CDR was recognised. The head of the institute in the 1990's, Al-Fadel Shalak was one of his associates, while its new headquarters – an old Ottoman palace – was renovated by Hariri. A few months after his appointment, Hariri announced 'Horizon 2000'. It was a 10-year perspective programme (1993-2002)

*"for recovery and balanced development, with the overall target of doubling per capita gross domestic product (GDP) over the period, thus allowing Lebanon to regain its position among the world's upper middle income nations".<sup>319</sup>*

The founders of the plan considered that, despite the destruction caused by the war, an efficient spending on infrastructure rehabilitation and expansion and the reactivation of the productive sectors would yield quick economic returns. These would allow for the recovery of costs in public utilities in a few years, and then generate the revenue surpluses necessary for offsetting public budget deficits, meeting debt repayment obligations, and accelerating economic recovery. The plan furthermore assumed that Lebanon was a country with high financial credibility for a set of reasons: the state had been keen on meeting debt repayments even during the war; the total public debt stock stood "to-day at no more than 53 per cent of GDP and 68 per cent of official reserves" (1993); and the large liquid assets held by Lebanese abroad would sooner or later find their way back home. Meanwhile, it stressed that without the private sector taking up its role, the reconstruction process would not proceed steadily.<sup>320</sup>

'Horizon 2000' sets two tasks for the government: to provide the private sector with an economic and financial environment conducive to the revitalisation of its activities and the resumption of its investments; and to consolidate public confidence in the state and in the future of the country.

#### **3.4.4.1 'Horizon 2000's' requirements for appropriate economic environment**

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<sup>319</sup> Republic of Lebanon, CDR, "Horizon 2000 For Reconstruction & Development". (1993) p.2.

<sup>320</sup> Ibid. pp. 3-4.

'Horizon 2000' states that the creation of an appropriate economic and financial environment for the private sector requires investments to be undertaken by the government. These are to include:

- The provision of suitable physical infrastructure, including electricity, telecommunications, water supply, wastewater collection and treatment, roads, public transport and railways, ports and airports and government buildings...etc.
- An acceptable social infrastructure related to housing and resettlement, public health, education...etc.
- The reactivation of productive sectors, including agriculture and irrigation, industry, oil, private sector services and tourism.
- Channelling the savings of the public to private sector investments through the banking system, which should be freed from mandatory subscriptions to treasury bills in order to be able to concentrate on financing productive sectors.
- Ensuring macroeconomic stability by having 'normal' inflation rates and a stable national currency. This is to happen through eliminating the public sector's current budget deficit.<sup>321</sup>

#### **3.4.4.2 Envisaged cost of recovery**

The public recovery expenditure was indicated in the base scenario of US\$ 11,672 m (at 1992 constant prices) over the 10-year period. This comprised US\$ 10,212 m for physical investment, US\$ 270 m for non-physical investments (institutional strengthening, programme planning and implementation support), and US\$ 1,190 m of grant and credit support to the private sector.<sup>322</sup> However, finance requirements of the plan did not stop at that level. The cost was envisaged to add up to about US\$ 14.3 bn when valued at the time of spending. Moreover, an additional US\$ 4.1 bn would be needed to meet budget deficits in the first two years, and debt repayment obligations throughout the period. Gross financing requirements would thus amount in total to some US\$ 18.4 bn in current prices over the 'Horizon' period.<sup>323</sup>

#### **3.4.4.3 'Horizon 2000' macroeconomic perspective**

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<sup>321</sup> *Horizon 2000 For Reconstruction & Development*, op.cit, pp. 4-5.

<sup>322</sup> *Ibid.* p. 8.

<sup>323</sup> *Ibid.* p. 14.

As mentioned earlier, the reconstruction plan aimed at restoring the real GDP to its pre-war level (1974) by 1995, and doubling the real GDP per capita in the period extending from 1992 to 2002. The aim was to move Lebanon into the group of upper middle-income countries.

Reducing public expenditure was the aim of the Base Scenario. The fiscal adjustment process had a target of progressive decline in expenditure from 26 per cent in 1993 to 15 per cent by 2002. Current public revenues, meanwhile (excluding any net revenues from public enterprises), were envisaged to increase from 13 per cent of GDP in 1993 to 20 per cent by 1998. The expected outcome was achieving a fiscal situation comparable with the group of upper middle-income countries.<sup>324</sup> A balanced government budget was to be reached in 1995 and, thereafter, the budget would register surpluses mounting up to 9 per cent of GDP by the year 2000. The expected current budget surplus starting from 1996 would constitute the principal source of financing public recovery expenditures as well as debt services requirements, the plan asserted.<sup>325</sup>

Government indebtedness is one of the definite results of 'Horizon 2000'. However, it will still be manageable according to the plan. The total debt stock was expected to rise from less than 50 per cent of GDP in 1992 to a peak of 84 per cent in 1995 and then to progressively decline to 39 per cent by 2002. As for foreign debt stock, it would peak at 37 per cent of GDP in 1996 before decreasing steadily to 16 per cent by 2002. Total debt repayments (principal and interest) would rise to 11 per cent of GDP in 1994 before declining consistently to 5 per cent by 2002.<sup>326</sup>

#### **3.4.4.4 'Horizon 2000' sources of finance**

Tapping the international market for foreign borrowing seemed to be the preferred source for the government in financing reconstruction. The plan assumed this would be the best option when current budget surplus would not be available. This argument was built on the "likely superior terms on official foreign currency borrowing compared to domestic currency borrowing (lower interest rates, longer maturity, and grace periods for capital repayments)". Domestic borrowing would be resorted to only in the case of

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<sup>324</sup> *Horizon 2000 For Reconstruction & Development*, op.cit, p. 12.

<sup>325</sup> Ibid.

<sup>326</sup> Ibid.

unavailability of current budget surplus and foreign currency borrowing. The plan stated that this strategy of maximising the level of foreign finance was to minimise the extent to which government domestic currency borrowing crowded out private sector domestic currency borrowing.<sup>327</sup>

'Horizon 2000' envisaged the contribution of foreign borrowing in the total public recovery expenditure to be 34 per cent (US\$ 4.9bn) over the 10-year period. No foreign borrowing was anticipated to finance non-recovery expenditures. Domestic currency borrowing for investment purposes would be "relatively modest" (6 per cent of recovery expenditure). However, these would remain a significant source of meeting gross financing requirements (19 per cent), the plan emphasised. The role of domestic borrowing was still central, however, as it was expected to sustain the financing of some US\$ 2.6 bn of other requirements (current budget deficits and debt repayments). Meanwhile, a shift from borrowing from the banking sector to borrowing from the public was to be introduced. This reduction in the government indebtedness to the banking system by reducing the compulsory financing of public sector operations would shift the banks' focus towards funding the private sector activities, the plan anticipated. Foreign grants were expected to contribute 6 per cent of expenditure, while receipts of interest and principal repayments under the credit support programme would contribute 4 per cent.<sup>328</sup>

The major envisaged source of funding, however, was the expected budget surpluses which would contribute 47 per cent (US\$ 8.4 bn) of gross financing requirements over the 'Horizon' period, meeting US\$ 7.1 bn (50 per cent) of the US\$ 14.3 bn recovery programme requirements and US\$ 1.6 bn (or 38 per cent) of other requirements. The plan reiterated, however, that budget surpluses would depend on the fulfilling of the fiscal adjustments and achieving surpluses in the revenues of EDL (Electricite du Liban) and Telecoms, targeted by the Base Scenario.<sup>329</sup>

However, the dependence on sources of finance varied from a period to another within the 'Horizon 2000' period, which was divided into two sub-periods.

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<sup>327</sup> *Horizon 2000 For Reconstruction & Development*, op.cit, p. 13.

<sup>328</sup> Ibid. p. 134.

<sup>329</sup> Ibid. p. 127.

First period (1993-1997): Gross financing requirements were US\$ 9.6 bn, of which US\$ 7.2 bn (75 per cent) relate to public recovery programme. Sources of finance were expected as follows:

Foreign currency borrowing	44 %
Domestic currency borrowing	34 %
Current budget surplus	14 %
Foreign capital grants	7 %
Repayments under credit programme	1 %

Second period (1998-2002): Total financing requirements were expected as US\$ 8.8 bn, of which public recovery expenditures amount to US\$ 7.1 bn (80 per cent). Sources of finance were envisaged as follows:

Current budget surplus	84 %
Foreign currency borrowing	7 %
Repayments under credit programme	5 %
Foreign capital grants	2 %
Domestic currency borrowing	2 %

*Source: 'Horizon 2000' p. 134.*

#### **3.4.4.5 Feasibility of the 'Horizon 2000'**

The above was a brief summary of the Hariri government's plan for reconstruction. It can be argued that this plan looks impressive at first glance. However, the best that can be said about it is that it was very optimistic. In some aspects, one could go further and describe it as superficial. The macroeconomic assumptions were not built on strong bases. Meanwhile, it seemed to show the best scenario ignoring completely any precautions for the worst scenario. No wonder that there was a mixed feeling amongst Lebanese officials and economists towards 'Horizon 2000'. These feelings can be topped by Hariri's remarks in 1997 that 'Horizon 2000' was not "a bible but a plan prepared by human beings" to which the government was sticking as much as possible and making alterations if needed. Yet he still believed that the programme "was

progressing on the right track".<sup>330</sup> Economists had a different approach, questioning the suitability of the plan. An official source in the Ministry of Finance, under Hariri, commented that 'Horizon 2000' was never put into implementation because it did not need a great economist to show its inapplicability.<sup>331</sup> Hamdan, as well, asserted that a few calculations could easily reveal the faults of the plan.<sup>332</sup> A funny comment on the official denial of the usage of the plan described 'Horizon 2000' as an "orphan that no one is willing to adopt".<sup>333</sup> Among the assumptions that can be criticised are the following:

- The plan assumed that public sector investment in rebuilding the infrastructure would definitely generate economic activities that would be enough to cover the budget deficit and meet debt repayments. By creating a suitable environment for investments, the government believed the private sector would be keen to get involved and thus instigate growth. However, as much as the need for infrastructure to attract investment is true, even with the best infrastructure the response of private sector cannot be guaranteed. The local businesses might have an interest in business opportunities. However, any hesitation or delay in their response, due to particular uncertainties, would leave the government with the problem of covering a growing budget deficit due to maximising debt repayments.
- The assumption that Lebanon is a country with high financial credibility is to a great extent questionable, given the bases on which the plan built the assumption. Firstly, the usefulness of government keenness on meeting debt repayments through the years of war is arguable. The amount of debt accumulated during the war was still manageable compared to what it would be like once the reconstruction process kick-started. Moreover, the government was depending on borrowing to finance its deficit, hence the steady increase in debt during the war period. Secondly, the fact that the total public debt stock was standing at no more than 53 per cent of GDP and 68 per cent of reserves in 1993, does not contribute remarkably to justifying Lebanon's high financial credibility. As mentioned earlier, a huge increase in public debt was expected once reconstruction started due to the need for massive funds. This implies that the amount of public debt compared to the GDP would be much

<sup>330</sup> Interview with PM Rafiq Hariri in *Lebanon 1997-8. The Annual Business, Economic and Political Review*, op.cit, p. 32.

<sup>331</sup> Author's interview with Mazen Hanna. Advisor at the Ministry of Finance during Hariri's period. Beirut July 1998.

<sup>332</sup> Author's interview with Dr Kamal Hamdan. Lebanese economist. Beirut. July 1998.

higher (84 per cent in 1995 according to the plan). Therefore, in the case that the expected economic growth and increase of revenues did not occur, the public finances would be problematic. Thirdly, the plan highlights the government's belief in the certain influx of large liquid assets held by Lebanese abroad. This proved to be a very optimistic presumption. The expatriate capital proved to be cautious about returning to Lebanon due to the uncertain political and economic situation. Significant sums of the capital influx after the end of the civil war, for instance, quickly found its way out after the first economic turbulence. Besides, presuming that the expatriate capital would respond, there were no guarantees for the crucial role it would play in the economic recovery process. The previous experience with influx capital showed that investments in T-bills and real estate were preferred to any other productive investments. Therefore, it was uncertain whether expatriate capital would flow into Lebanon, and if it did, its productive influence was not guaranteed due to very lack of short-term commitments. Thus, Lebanon's high financial credibility needed a stronger base to be justified.

### **3.4.5 The policies of Hariri's government in practice**

#### **3.4.5.1 Monetary achievements**

Hariri arrived into the office of PM in the midst of an economic crisis in Lebanon, which reflected in the massive depreciation in the value of the Lebanese Pound, high dollarisation in deposits, and inflation reaching 120 per cent. After his arrival, he pledged to combat inflation and stabilise the national currency. Indeed, he succeeded in fulfilling his promise as the rate of exchange rose from LL 2,248 to US\$ 1 in October 1992 to LL 1,528 in December 1997, regaining 32 per cent of its value.<sup>334</sup> Inflation fell from as high as 100 per cent on the eve of his arrival in office to 29 per cent in 1993, and just 8 per cent in 1997.<sup>335</sup> Dollarisation fell from around 70 per cent of deposits in 1993 to 56.5 per cent by the end of 1996.<sup>336</sup> Foreign exchange reserves that had been exhausted defending the Lebanese Pound against depreciation in the previous years

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<sup>333</sup> Author's interview with Dr Antoine Haddad, Lebanese economist. Beirut. July 1998.

<sup>334</sup> Banque Du Liban. *Annual Reports*. (1995). p.56 & (1997). p.58.

<sup>335</sup> Banque du Liban. *Annual Report* (1995). p.15.

<sup>336</sup> Banque Du Liban. *Annual Report* (1996) (Arabic version). p.38.  
(The IMF at 53 per cent for the end of 1996)



were beefed up again. Gross official reserves of foreign exchange rose from US\$ 1.2 bn to over US\$ 6.1 bn in 1998.<sup>337</sup>

However, it has to be said that these monetary achievements were supported by other monetary measures that had an adverse effect on the economy. The government had resorted to funding its expenditure through borrowing from the domestic market at high interest rates. In this sense, it followed the pattern followed by previous governments in financing public expenditure. Interest rates on T-bills reached over 37 per cent in 1995. Such high rates were required to finance public expenditure and to defend the Lebanese Pound during periods of political uncertainties. However, the effect of the high interest rates on the economy was dismal. The government had crowded out the private sector from the economic cycle by depriving it of funding. It destroyed the chances of the private sector to receive affordable loans from the banking sector. The latter was 'seduced' by the lucrative interest rates offered by the government on T-bills. Therefore, the government had contradicted the core of its 'Horizon 2000' plan, which envisaged a crucial role for the private sector in reactivating the economic cycle. Loans to the public sector reached LL 13,234.17 bn (US\$ 8,666.7 m) in 1997, while loans to domestic private sector totalled LL 15,451.25 bn (US\$ 10,118.70 m).<sup>338</sup> Therefore, if domestic lending had totalled LL 28,685.43 bn (US\$ 18,785.48 m), the public sector has seized 46 per cent of it. The greatest harm had been done to the productive sectors. Industrialists had only a very slim chance of receiving soft long-term loans from the domestic banking sector. Instead, only short-term, trade-oriented activities were financed. By 1997, only 12.44 per cent of banking loans to private sector went to industry, while agriculture received just 1.49 per cent. Moreover, lending to the private sector was characterised by high dollarisation. Loans in US dollars amounted for US\$ 8,817 m in 1997, representing over 87 per cent of total loans to the domestic private sector. This was due to uncertainty about the Lebanese Pound giving preference to dollar lending on the banks' side, and also to the high interest rates on Lebanese Pound borrowing, on the borrowers' side. On the other hand, the rate of the Lebanese Pound had been criticised for being over valued. A report by Flemings considered that the nominal value of the Lebanese Pound was 44 per cent over its real value in 1998. It

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<sup>337</sup> Ibid.

<sup>338</sup> Banque du Liban. Annual Report (1997). (Arabic version) p.40.

stated that the monetary authorities interfered frequently to defend the rate of the currency.<sup>339</sup>

### **3.4.5.2 Fiscal achievements**

Hariri pledged in his government's proposal to win the vote of confidence to eliminate budget deficit by controlling expenditure and increasing revenues. To do so he promised an improvement in the collection of taxes after reforming the taxation system on social and economic criteria, and the levy of all custom duties.<sup>340</sup> The 'Horizon 2000' plan had stated that macroeconomic stability was to be achieved by eliminating the public sector's current budget deficit.<sup>341</sup> Indeed, 'Horizon 2000' had promised a "wipe out" of the budget deficit by 1995 and an increased budget surplus thereafter.<sup>342</sup> Here again, the plan and Hariri himself were very optimistic in assuming a sufficient increase in revenues and controlled expenditure.

Government' revenues that were almost non-existent by the end of 1980s had improved slightly with the restoration of government's authority over major sources of revenues. However, these were still insufficient as they totalled only LL 1,059 bn at the time of Hariri's arrival into office in 1992. This covered only 47.7 per cent of expenditure in the same year.<sup>343</sup> To increase revenues, the government embarked on fiscal reforms. The new government improved the collection of custom duties, which are traditionally the main source of government revenues. The figures of these duties have between 1992 and 1993 reached LL 663 bn and accounted to 35.7 per cent of total revenues. These figures saw a steady growth in the following years. The share of indirect taxation in revenues jumped to LL 743 bn and LL 921 bn in 1993 and 1994 respectively. They had amounted to only LL 467 bn in 1992.<sup>344</sup>

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<sup>339</sup> Flemings: Research, *Currency Risk in EMEA, The Outlook for 1999*. (London: Robert Flemings Securities. 30 December 1998). p. 28.

<sup>340</sup> See Hariri's speech earlier in this section on reconstruction.

<sup>341</sup> See the section on "Horizon 2000".

<sup>342</sup> Ibid.

<sup>343</sup> Statistics derived from "Lebanon 1997-8. op.cit, p.49.

<sup>344</sup> Ibid.

As for taxation, the new government introduced a new tax reform in 1993 cutting personal and corporate income tax rates "to encourage compliance with tax payments and attract foreign investments".<sup>345</sup> The new reforms included the following:

- Profit taxes: The rate of profit taxes applicable to individuals involved in commercial, industrial and professional activities used to range from 6 per cent to a maximum of 50 per cent. The new reform slashed these rates to a flat rate of 10 per cent on financial companies, and a progressive rate from 2 to 10 per cent on industrial and commercial companies.
- Taxes on wages and salaries: These rates had thirteen income brackets ranging from a minimum of 2 per cent to a maximum of 32 per cent on incomes that exceeded seventy times the minimum wage. However, there was a concentration in the low-wage earners as 92 per cent of the individuals had tax rates lower than 8 per cent. Only 1 per cent paid over 19 per cent in taxes. The new law slashed tax rates to a maximum of 10 per cent, while the minimum rate was 2 per cent. The latter was applied to annual incomes not exceeding LL 5 m (around US\$ 3,330), while the former applied to incomes exceeding LL 75 m (US\$ 50,000).
- Taxes on capital accounts: These included stocks and bills issued by public and private institutions on which a flat rate of 5 per cent was imposed. However, other instruments like saving and current accounts, and Lebanese government T-bills were completely exempted from tax charges.<sup>346</sup>

Taxes on property and its usage were amended while others remained untouched. As stated earlier, the declared motive behind this tax reform was to encourage compliance with payment (i.e. restrict tax evasion) and attract foreign investments. The revenues from direct taxation, in addition to maximised indirect taxation, were supposed to boost the treasury with cash inflows to offset the chronic budget deficit in government expenditure.

However, if the promise to increase government revenues was conceivable, as government revenues could not get worse by the time Hariri became PM, the promise to control public expenditure was questionable. One would wonder about the bases on which Hariri and the 'Horizon 2000' built their promises. Hariri had pledged at the same time to embark on a massive reconstruction process that needed huge sums of

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<sup>345</sup> Dah, A, The Distributional Impact of Taxes in Lebanon: Analysis and Policy Implications. (Beirut, LCPS: 1999) p. 8.

money. His government also had the immediate task of stabilising a devastated national currency and restoring confidence in the country's economy. The money needed for the reconstruction process was not available and aid did not seem to flow in as expected. Meanwhile, the increase in revenues was not enough. Revenues rose to LL 2,241 bn in 1994, of which direct taxation represented only 12.9 per cent. The increase in revenues was around 24 per cent. However, it was accompanied by about 65 per cent surge in public expenditure which reached LL 5,204 bn.<sup>347</sup> The major components of public expenditure were the salaries for public sector employees (32.9 per cent); interest payments on domestic debt (28.3 per cent); and investment expenditure (24 per cent). The latter had represented a massive leap as it stood at LL 146 bn and LL 393 bn in 1992 and 1993 respectively.

With the lack of revenues, the government resorted to borrowing from the domestic market. The domestic borrowing was double edged as it funded the public expenditure deficit on the one hand, and helped defend the Lebanese Pound and reduce inflation, on the other. However, this resulted in the accumulation of public domestic debt that jumped from a gross total of LL 6081.8 bn in 1993 to LL 9320 bn in 1994. In 1995, these figures increased significantly to LL 12,974.3 bn (around US\$ 8.5 bn), and by the end of 1997 they reached LL 19,589.1 bn (over US\$ 12.8 bn).<sup>348</sup> Foreign debt that had been as low as US\$ 327.5 in 1993, increased gradually to US\$ 771.8 bn and US\$ 1,304.6 bn in 1994 and 1995 respectively. By the end of 1997 it had reached US\$ 2,404 bn.<sup>349</sup> However, the slow pace of foreign debt was not due to government's intention not to borrow from the international market, but due to the lack of available loans. Indeed, the Hariri's government had declared its preferential position towards foreign debt as opposed to domestic one.

More borrowing meant higher interest payments burdening the budget. These amounted to over 65 per cent of revenues in 1994. The budget deficit/expenditure reached 56 per cent (19 per cent of GDP) in the same year.<sup>350</sup> The 1995 budget registered 48 per cent deficit/expenditure (15.6 per cent of GDP). This was below the expected 44 per cent budgeted deficit, and was due to a sharp increase in T-bills interest rates. The latter was

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<sup>346</sup> Dah, A, *The Distributional Impact of Taxes in Lebanon*, op.cit, pp. 8-12.

<sup>347</sup> Banque du Liban, *Annual Report* (1996) p.71.

<sup>348</sup> Ibid. (1996) p. 72 & (1997) p. 77.

<sup>349</sup> Ibid.

<sup>350</sup> Statistics derived from *Lebanon 1997-8*, op.cit. p. 49.

because of the presidential election crisis, which threatened the stability of the Lebanese Pound.<sup>351</sup> The year 1996 was not better despite the fact that the expected budget deficit/expenditure was 37.7 per cent, and revenues were projected to increase to cover the primary budget. Contrary to all these expectations, revenues were below the projected figures while expenditure shot higher than anticipated. That was attributed to political unrest resulting from the Israeli 'Grapes of Wrath' attack in April and the parliamentary elections in the summer. Instead, budget deficit/expenditure registered 51.1 per cent (18 per cent of GDP).

#### **3.4.6 Macroeconomic picture in 1998**

The year 1998 was the eve of Hariri's departure from office, although such a development was not expected by any one, not even by Hariri himself. The election of the new president, Emile Lahoud, proved to be a setback for Hariri's power. The new president, coming from the army institution, was not prepared to tolerate the unlimited powers of Hariri. The latter decided to step down, reiterating his support for the new president. However, it is worth looking at the economic situation of Lebanon on the eve of Hariri's departure.

Unequivocally, the Lebanese economy witnessed a remarkable prosperity after the arrival of Hariri. The real GDP rose by 7 per cent and 8 per cent in 1993 and 1994 respectively. It reached US\$ 7.67 bn and US\$ 9.29 bn in the same period. However, growth registered a turn in 1995, amounting to only 6.5 per cent and continuing to fall in 1996 to 4 per cent.<sup>352</sup> In 1997, the Ministry of Finance projected an upturn in GDP growth to 7 per cent. However, the GDP growth deteriorated further to 3.5 per cent.<sup>353</sup> By 1998, the GDP growth rate hit a low record of 2 per cent.<sup>354</sup> It was suggested that the remarkable growth in GDP figure had been due to huge capital inflows that were channeled into reconstruction. These were estimated at US\$ 7 bn annually up to 1998.<sup>355</sup> However, the components of the GDP suggested a large bias to the interest component, which did not reflect real growth.<sup>356</sup>

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<sup>351</sup> Ibid.

<sup>352</sup> Ministry of Finance. *Budget Report 1997*. p.8.

<sup>353</sup> EIU *Country Profile 1999-2000*. p.37.

<sup>354</sup> Ibid.

<sup>355</sup> Ibid. p.18.

<sup>356</sup> Author's interview with Dr Kamal Hamdan. Lebanese economist. op.cit.

The rate of dollarisation was still around 60 per cent of total deposits by the end of 1998.<sup>357</sup> Interest rates on T-bills were still over 15 per cent on 1-year bills.<sup>358</sup> Meanwhile, inflation in prices was estimated at a rate of 4.8 per cent.<sup>359</sup> The balance of trade registered a deficit of US\$ 5,808.81 m by the end of 1998, while the balance of payments registered a deficit of US\$ 487.6 m, compared to a surplus of US\$ 419.8 in 1997.<sup>360</sup> However, it has to be mentioned that the surplus in 1997 was instigated mainly by a US\$ 600 m deposit that came from Saudi Arabia to support the Lebanese economy.<sup>361</sup> Total domestic debt increased to LL 21,685.7 bn, registering a 9.6 per cent increase from 1997. Foreign debt hiked to US\$ 4,177 m in 1998, increasing by 75.87 per cent from 1997's figure of US\$ 2,375 m.<sup>362</sup> Total gross debt stood at LL 27,951.2 bn.<sup>363</sup> by the end of 1998. The ratio of public debt/GDP reached over 110 per cent in 1998.<sup>364</sup>

After seeing all these frightening figures, which seemed to indicate the collapse of the economy of Lebanon, one wonders if Hariri did any good to Lebanon. The answer to this question is obvious by conducting a comparison between Beirut's conditions before 1993 and after 1998. Hariri did indeed fulfil his pledge to build the country's infrastructure to a great extent. Before Hariri, electricity was a rare commodity, telephones did not exist, wastewater was mixed with drinking water and solid waste was 'decorating' the streets. The 1960s-70s road network was heavily congested, Beirut International Airport was in a disgraceful condition, and the central district of Beirut was a ghost town. By 1998, new electricity networks reached the furthest villages of Lebanon, telephone services that were considered a 'blessing' became abundant, new infrastructural networks for wastewater and storm water were built, while garbage is now collected around the clock. The road system came a long way with new motorways, tunnels and flyovers that eased congestion in Beirut and improved connections with the regions. The completed section of the new airport is indeed state-of-the-art, and the central district of Beirut is emerging as an impressively modernised town centre with the most possibly preserved historical architecture of the past. The list

<sup>357</sup> Banque du Liban. *Quarterly Report*. Fourth Quarter 1998. p.12.

<sup>358</sup> *Ibid.*

<sup>359</sup> EIU. *Country Profile 1999-2000*. p.37.

<sup>360</sup> Banque du Liban. *Quarterly Report*. 4<sup>th</sup> Quarter 1998. p.22.

<sup>361</sup> Banque du Liban. *Annual Report* (1997) p.21.

<sup>362</sup> Banque du Liban. *Quarterly Report*. 4<sup>th</sup> Quarter 1998. p.24.

<sup>363</sup> The external debt was converted at 1998 current rate of US \$ (EIU rate: LL 1,516)

<sup>364</sup> GDP was estimated by the EIU at LL 25,374 bn in 1998.

is fairly long, particularly, if we mention the new giant Sports Complex built by Kvaerner, and the expanded port of Beirut, etc.

These achievements were not negligible. They changed the whole image of Lebanon from a country destroyed by a ferocious civil war to an inhabitable and welcoming country. However, the argument that can be raised here is about the methodology followed in the reconstruction plan, the cost that appears much higher than the achievements, and the distribution of resources amongst the regions and sectors to achieve the socio-economic development that Hariri pledged at the beginning of his era. What is meant here by the methodology followed in the reconstruction process is the way available funds were allocated. The issue of prioritising and phasing did not seem to appeal to Hariri's government. Although the reconstruction plan 'Horizon 2000' was divided into two phases, this did not seem to apply to projects. The government decided to build a new telephone network, which was desperately needed. However, it is questionable whether Lebanon really needed a vast network of over 1 million lines. A new airport was certainly a positive change, yet a 6 million airport is a bit over ambitious as the accomplished part of the new airport seemed to be sufficient in 1998.

Concerning the cost of reconstruction, it is striking to see that the Lebanese government accumulated debt of over US\$ 16 bn between 1993-98 for what was achieved. However, the heavy burden of expenditure has not been created by the cost of construction only. The money allocated for investment in the budget between 1993-98 was LL 6,103 bn (US\$ 3,996.7 m).<sup>365</sup> This represented 16.15 per cent of a total budget expenditure of LL 37,784 bn in the same period. Meanwhile, investment expenditure from outside the budget was over LL 2,168 bn. This means around 20.70 per cent of government spending (over LL 39,952 bn) was allocated to investment.<sup>366</sup> Therefore, the treasury was exhausted by other current expenditure, most prominently interest payments on public debt and public sector salaries and wages. Hariri admitted that 32 per cent of his governments' expenditure (assessed by him at US\$ 28 bn) went to servicing debt. He added that 19 per cent of spending financed the Army and Internal Security Forces, while 19 per cent was spent on social affairs. According to Hariri, 20 per cent was channeled into reconstruction, as well as tourism, agriculture and

<sup>365</sup> Exchange rate LL 1,527 = US\$ 1.

<sup>366</sup> Statistics assessed by the author depending on figures derived from Banque du Liban reports.

industry.<sup>367</sup> Indeed, statistics show that 35.33 per cent financed the debt servicing (LL 13,348bn) while 31.97 per cent of budget expenditure covered public sector salaries (LL 12,081 bn) in the same period. Very little was left for investments in a budget that was already exhausted with deficit.

The third argument concerning the distribution of resources between sectors and regions can be justified by the disappointing attention given to the productive economic sectors, and the unsatisfactory regional development. The government had focused on building infrastructure as its major task to stimulate the private sector. However, the private sector in productive sectors (manufacturing and agriculture) needed finance and government support for rehabilitation. However, the finance was snatched by the government itself from the path of the private sector. The government, as mentioned earlier, ended up crowding out private sector in its search for capital to finance its expenditure. Infrastructure is essential but has to be accompanied by development in other sectors that can benefit from its development. Kubursi stated that the “size, timing, nature, and costs of this infrastructure should be determined by its contribution to growth and its capacity to raise sufficient revenues to pay for it”.<sup>368</sup> Meanwhile, agriculture as well received very little attention from the government. This is part of the regional socio-economic development that the government did not manage well. Supplying electricity and extending telephone networks is fine, but this needs economic activities to pay for these services. On the other hand, supporting agriculture would contribute to social stability by restricting migration from rural areas. However, the government failed, for instance, to create alternatives for farmers who were forced to abandon opium growing in the Bekaa area. No wonder the region of Northern Bekaa witnessed social upheavals in 1997 with demonstrations requesting attention from the state. In this sense the Hariri government and its reconstruction plan failed. Kubursi suggested that the reconstruction plan and the vision driving it had suffered from many structural biases. These were “an urban bias (in contrast to a rural-urban balance), a cement bias (in contrast to a balance between human development, technology, and construction), an import bias (in contrast to encouraging exports and domestic

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<sup>367</sup> Interview with Ex-PM Rafiq Hariri, in *Emerging Lebanon 2000*. op.cit, p.23.

<sup>368</sup> Kubursi. A, Reconstructing the Economy of Lebanon. *Arab Studies Quarterly*. (21), no.1, Winter 1999 p. 82.



production), and a services bias (in contrast to a balance between commodity producing sectors and non-commodity producing sectors)."<sup>369</sup>

The faulty policy followed in the reconstruction process resulted in its failure. The weak assumption that prosperity is unequivocal once infrastructure is set up failed miserably. The accompanying political instability did not help the situation either. The presidential re-election crisis in 1995, the Israeli attack in April 1996, the presidential elections in 1998, and numerous quarrels between Lebanese top politicians contributed to the 'miscarriage' of the reconstruction process.

### **3.5 Conclusion**

Lebanon established a friendly environment for foreign businesses through the *laissez-faire* capitalist system that it developed successfully after independence. It was certainly affected by the mercantile mentality of the Lebanese elite that shaped the economy over the mandate period aided by their French patron. Lebanon consequently stood out amongst the neighbouring countries in the 1950s-60s when these were turning into curtailed state-led economies. Lebanon's free-market system enabled its economy to benefit from all the changes taking place in the region: The creation of Israel diverted Haifa's maritime traffic to Beirut, the flight capital that survived the land reform and the later nationalisation in Egypt and Syria found refuge in Lebanon's banking secrecy, and oil-generated-dollars needed a developed banking system to look after them. Thus, the foreign interest in Lebanon was not surprising. However, this interest was concentrated in the services sector, particularly finance. Foreign banks set up branches and representative offices to take a share of the business being generated. They were also serving the regional market, mainly the Gulf, by a proxy, which was Beirut. Foreign businesses got involved as well in other sectors of services. Particular reference can be given to the number of international hotels that started operations in Beirut, and airlines that used Beirut airport as a connection centre. However, the concentration of foreign businesses in services and trade was accompanied by a complete neglect of other economic sectors. Manufacturing and agriculture were out of the foreign focus. That can be attributed partly to the services-orientated economy of the country. Other productive sectors had never been appealing for foreign investment as they were still

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<sup>369</sup> Kubursi. A, *Reconstructing the Economy of Lebanon*, op.cit.

underdeveloped. Lebanon did not have comparative advantages to attract foreign investment from Europe, or elsewhere, into manufacturing industry and agriculture. Meanwhile, it had an increasingly developing high-consuming market to attract European exports. The developed financial and non-financial services were certainly a comparative advantage for Lebanon into which foreign business interests flowed. However, the civil war has destroyed all the achievements of the previous two-decades. Lebanon's services sector lost its prominent position in the region, and interest was diverted to other regional centres.

In the post-civil war period, the Lebanese government embarked on a massive reconstruction plan aimed mainly at regaining Lebanon's prominent position in the region. Part of the strategy was to attract foreign investments. The Lebanese government realised the importance of private foreign capital in the process of economic development. The government issued numerous decrees offering incentives for private businesses, including foreign. Hence, the decision to slash personal and corporate income taxes, and the tendering of many projects on B.O.T. basis. The massive infrastructure rehabilitation was seen by Hariri and his governments as a necessity to encourage private and foreign businesses. The response of foreign firms will be discussed in the following chapters. However, the failure of the government to tackle economic problems and the accumulating public debt and budget deficit has exacerbated the already dire situation and counter-acted measures intended to attract FDI. Indeed, the current Lebanese economy holds little appeal, even for those companies who did business in Lebanon prior to the civil war. While the reconstruction plan created massive opportunities, the rest of this thesis will examine whether EU private investment capital has responded to them.

# PART TWO

## **Chapter Four: Theoretical Approach to The Motives for Firms Engagement in FDI Activities – Theories of Foreign Direct Investment**

### **4.1 Introduction**

Part One of this thesis provided the background material and context for a study of EU business activities in Lebanon in the contemporary period, and specifically European FDI. Chapter One established the historical commercial links between Europe and Lebanon, indicating the special relationship that existed between France and Lebanon. Chapter Two examined the impact of the creation and development of the EU on European business links with Lebanon. It showed the continuing dominance of trade over investment in that relationship, establishing the one-way nature of that trade, and the Lebanese demand for European consumer items. It also showed that, despite the growth of concerns within the EU over the requisites of economic development in southern Mediterranean states like Lebanon, little has been done until now to actively encourage private FDI from within the EU towards those countries. This may change if Lebanon and the EU reach a partnership agreement. However, Chapter Three established the continuing economic weakness of Lebanon and the failure of the Lebanese governments during the modern era to put in place either the economic conditions or comprehensive policy packages that would attract such investments.

In Part Two of this thesis, I will examine the extent and nature of European business activity in Lebanon in the present era, with the aim of establishing exactly how much of that activity falls within the category of FDI. In order to ascertain precisely why that activity has been so limited, it is first necessary, however, to determine the criteria by which FDI decisions are made. Chapter Four will therefore draw on established theories of FDI to propose such a list of criteria.

### **4.2 Defining foreign direct investment (FDI)**

Foreign direct investment (FDI) is one of the two types of long-term private international capital movement, the other being portfolio investment. The focus of this thesis is foreign direct investment. However, a distinction between the two types of investment should be mentioned, as they are similar in many aspects.

Dunning said that direct investment implies that the investing unit (usually a business enterprise) purchases the power to exert some kind of control over the decision-taking process of the invested-in unit (again, usually a business enterprise). Something other than money is involved in international direct business. This could simply be informal managerial or technical guidance.<sup>370</sup> On the other hand, he added, it could incorporate the dissemination of valuable knowledge and/or entrepreneurship, in the form of research and development, production technology, marketing skills, managerial expertise, and so on.<sup>371</sup>

Hymer argued that the distinction between direct investment and portfolio investment is a question of who controls the enterprise.<sup>372</sup> If the investor controls the enterprise, his investment is direct investment. If he does not, his investment is portfolio investment.<sup>373</sup> Czinkota meanwhile confined portfolio investment to the purchase of foreign securities, such as stocks or bonds, without implying any direct control over foreign operations.<sup>374</sup> On the other hand, direct investment entails much more than the purchase of securities. It is the establishment of overseas operations by a firm or the expansion of the existing operations.<sup>375</sup>

Reuber went further to encompass, under portfolio capital flows, governmental loans, loans by international agencies, borrowing via bonds and short-term loans, including bank loans and export credits.<sup>376</sup> In assessing the difference between the two types of international investment, he argued that portfolio investment in credit instruments implies a fixed obligation to repay interest and principal, whereas direct investment implies a flexible repayment obligation geared to the success of the investment. Portfolio flows, he added, tend to be more general in character than direct investment, which tends to be "industry specific". Moreover, portfolio investment does not directly affect local ownership and control, whereas direct investment gives rise to non-resident ownership and control. Finally, Reuber noted that portfolio investment normally implies

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<sup>370</sup> Dunning. J. H, Studies in International Business (London: George Allen & Unwin, 1970), p. 4.

<sup>371</sup> Ibid.

<sup>372</sup> Hymer. S.H, The International Operations of National Firms: A Study of Direct Foreign Investment. 1976. (MIT Press: 1976) p.1.

<sup>373</sup> Ibid.

<sup>374</sup> Czinkota. M, International Business. 2nd ed, ( Dryden Press, 1992) p.26.

<sup>375</sup> Ibid.

<sup>376</sup> Reuber. G, Private Foreign Investment in Development. (Oxford, Clarendon Press: 1973) p.53.

a transfer of capital only, whereas direct investment usually comprises a transfer of auxiliary factors in addition.<sup>377</sup>

Clearly, the control exercised by the investing company over the overseas venture is the most crucial factor in distinguishing FDI from portfolio investment. Notably, the US Department of Commerce defines a foreign investment as direct when a single investor has acquired a stake of a minimum of 10 per cent in a US firm. It was assumed that a 10 per cent shareholder is a strong shareholder and would have a strong say in the operations of a firm.<sup>378</sup> However, the same source has reiterated that firms that are integrated into the control structure of foreign-based multinational firms are those with a single foreign parent-firm establishing unambiguous and undisguisable control.<sup>379</sup>

### **4.3 Theories of foreign direct investment**

#### **4.3.1 Classical Theory of International Investment**

Taoka suggests that classical theory considers that international capital movements are due to the differences in interest rates among countries. Funds will flow from areas of abundant capital where interest rates are low to areas of capital scarcity where interest rates are higher. However, he added, although it is often advanced as a theory of foreign direct investment, this theory is more appropriate for explaining indirect or portfolio investment.<sup>380</sup>

Czinkota explained that the classical theory of direct investment suggests that the motive for international direct investment is profit maximisation. Factors of production will tend to gravitate toward the location where the highest rate of return can be earned.<sup>381</sup> The essence of the classical theory, stated Czinkota, is quite simple: productive resources will seek out the highest return. The logic is an extension of classical trade theory. Capital-rich countries will tend to export capital-intensive goods and to invest capital abroad. Labour-rich countries on the other hand, will export labour-

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<sup>377</sup> Ibid.

<sup>378</sup> Graham. E. M, Foreign direct investment in the United States. (London: Longman, 1995) p. 9.

<sup>379</sup> Ibid.

<sup>380</sup> Taoka.G, International Business, Evironments, Intitutions, and Operations. ( HarperCollins, 1991) p.48.

<sup>381</sup> Czinkota. M, op.cit, p. 26.

intensive goods and find that the labour force will have a tendency to migrate to richer countries.<sup>382</sup>

The argument is based simply on the differences in the cost of capital. Letto-Gillies noticed that the literature on foreign investment before Hymer's thesis (1960s) was based on neo-classical assumptions "and it ran mostly parallel to the neo-classical theory of trade".<sup>383</sup> He referred here to the ideas of Ohlin (1933) and Iverson (1935), in addition to others. No distinction was made between portfolio and direct investment. It was all put within the framework of international capital movement. When discussing the reasons behind capital movements across countries, Ohlin, a major classical theorist, also argued that the difference in interest rates is the greatest stimuli to export and import of capital. Obviously, this argument remained as the core of the classical theory, to be echoed by Taoka and others. "Countries where the rate of interest is low find it profitable to export capital to countries where the rate is high".<sup>384</sup> However, it is not wholly explained this way, he noticed. Political considerations and capitalists' preferences for a diversity of investments can decisively influence the flow of capital movements between countries, without any need for great differences in interest rates. He argued that "investment trusts in particular attempt to spread their capital over securities in such a way as to reduce risks, and partly for this reason they buy foreign securities as well as domestic". He also noted that "such trusts have been important instruments for the exportation of British capital".<sup>385</sup>

In what can be considered as referring to foreign direct investment, Ohlin pointed out that the establishment of branch offices and factories by manufacturing firms in foreign countries is another way of international capital movement as capital would be transferred, in most cases, from the home country of the firm. He explained that firms resort to establishing production in countries that are protected by high tariffs to avoid such trade barriers. These companies might also be motivated by the desire to guarantee the supply of foreign raw materials. However, Ohlin argued that the establishment of great international enterprises does not invariably cause capital's transfer from the home country of the firm, as it might be borrowed from anywhere else. "Firms such as the Dutch Shell Company, with branches in a dozen countries, find it easy to borrow capital

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<sup>382</sup> Ibid, p.27.

<sup>383</sup> Letto-Gillies, G, *International Production: Trends, Theories, Effects*. (Polity Press: 1992) p.78.

<sup>384</sup> Ohlin, B. G, *Interregional and International Trade*. (1967) p. 210.

in different countries, wherever the interest rate is low.”<sup>386</sup> He considered this a proof for his previous argument that capital is normally exported from countries that have low interest rates.

On this point, Iversen argued that the largest quantity of capital which can be transferred from one country to another in a given period, is the total amount of free disposable capital available in the period.<sup>387</sup> He also believed that differences in interest rates are the main motive for capital movements. Foreign investment involves higher risks than domestic investment, and that is why lenders would expect higher interest in overseas countries than at home.<sup>388</sup> Ohlin concluded that capital movements are like migrations, they “vary decidedly from one phase of the business cycle to another”. They are affected by the state of trade in general and the largest capital movements occur during boom periods, he added.<sup>389</sup>

#### **4.3.2 International Product Life Cycle Theory**

This theory suggests that a firm’s investment abroad is part of an international life cycle of products or processes.<sup>390</sup> Although it is a trade theory, this theory is believed to have important implications for foreign direct investment, and that patterns of trade and investment depend on the life cycle stage of the firm’s product.<sup>391</sup>

The life cycle of a new product progresses through five stages: introduction, rapid growth, competitive turbulence, maturity, and decline.<sup>392</sup> According to Czinkota, this theory suggests that the development of new innovative products is most likely to occur in industrialised countries. One reason is that these countries are likely to have the research and technological capabilities necessary for new-product development. Another is that wealthier countries are likely to generate demand for new products. Furthermore, the firm introducing a product will probably want to locate production facilities domestically. As a new product is unlikely to face serious price competition

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<sup>385</sup> Ibid. p.211.

<sup>386</sup> Ibid. p.211.

<sup>387</sup> Iversen, C. *Aspects of The Theory of International Capital Movements*. 1st ed 1935 (London: 1967) p.24.

<sup>388</sup> Ietto-Gilles. G, op.cit, p. 80.

<sup>389</sup> Ohlin. B, 1967.op.cit, p.213.

<sup>390</sup> Taoka. G, op.cit. p.50.

<sup>391</sup> Czinkota. M, op.cit, p.30.

<sup>392</sup> Taoka. G, op.cit, p.50.



initially, the firm will not be forced to build production facilities at the minimum-cost location. Production can therefore take place near the site of product development and research, where the production process can be monitored and adjusted.<sup>393</sup>

Taoka, however, considers that during this "introduction stage" products or processes are designed to meet the needs of the home market, and are produced domestically. Costs are high because the scale of production is quite small. At this stage, there are usually no international activities or at most, minimal exports, to similar markets.<sup>394</sup>

During the stages of rapid growth and competitive turbulence (combined in one growth stage with Czinkota), exports to other developed countries expand rapidly. Attempts to break the monopolistic position of the innovator firm erupt from home firms and other industrialised countries.<sup>395</sup> Czinkota pointed out that firms representing competition abroad have certain advantages over the exporter, as they would not be subject to quotas and tariffs on the sales they are able to generate, and that they would not have to incur sizeable transportation costs in getting the product from the producer to the consumer.<sup>396</sup> A result of this competition and supply capacity increase, according to Taoka, is a dramatic decline in market prices. This decline in prices and the resulting profit squeeze invariably results in more efficient methods of production and declining production costs. Taoka pointed out that these stages are often termed "wash-out" phases as firms that cannot achieve efficiency are forced to merge, are acquired, or go out of business.<sup>397</sup>

In the maturity stages, firms will begin to replace their exports with local production to avoid import barriers imposed by the host governments, transportation cost, and above all, to protect the foreign market. This will lead to licensing agreements or joint ventures with firms in foreign country, or to wholly owned investments.<sup>398</sup>

The decline stage occurs as a result of the increase in stiff competition from other producers forcing the company to compete as a low-cost producer. As a consequence, a manufacturing company will choose to shift production to a LDC where the cost of

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<sup>393</sup> Czinkota. M, op.cit, p.30.

<sup>394</sup> Taoka.G, op.cit, p.50.

<sup>395</sup> Ibid.

<sup>396</sup> Czinkota. G, op.cit, p.30.

<sup>397</sup> Taoka. G, op.cit, p.50.

<sup>398</sup> Ibid. p.51 &

production is cheaper. Taoka argued that imports begin to enter home country and other industrialised countries, and exports begin to disappear. During this stage, home country production disappears, as producers in developed countries can no longer meet the competition provided by imports.<sup>399</sup> Major developed countries' firms had set up plants in LDCs to retain their share in the global and domestic markets. Czinkota explained this decline as "while the initial direct investment was largely market motivated, the investment in developing-countries operations is cost motivated, because the product's survival now depends on the firm's ability to lower production costs".<sup>400</sup>

#### **4.3.3 Monopolistic - Oligopolistic Advantage Theory**

According to Taoka, this theory states that multinational corporations will invest abroad because of monopolistic or oligopolistic advantages due to any of several reasons. The advantages are assumed to overcome the disadvantages faced by a multinational corporation when it goes to an unfamiliar foreign market. "Each variant of the monopolistic-oligopolistic advantage theory places emphasis on a different factor but the general thrust is the same: The MNC possesses an exploitable factor that creates a monopolistic or oligopolistic advantage abroad or that will develop into an advantage if the firm invests abroad".<sup>401</sup> Oligopoly, according to Friedman, is a market having few firms (but more than one firm) on the supply side and a very large number of buyers on the demand side, each of whom makes a negligible contribution to the market demand function. "A buyer will take market conditions as given, for he cannot affect them, but a seller will inevitably be preoccupied with guessing the behaviour to be expected from rival sellers."<sup>402</sup> Knickerbocker stressed that in oligopoly the products of those few sellers are close substitutes for one another, and that there is a substantial interdependence among the competitive policies of these firms. "Oligopoly is a definition of both the structure of a market and the behaviour of the firm selling in the market."<sup>403</sup>

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Czinkota. G, op.cit, p.30.

<sup>399</sup> Taoka. G, op.cit, p.51.

<sup>400</sup> Czinkota. G, op.cit, p.30.

<sup>401</sup> Taoka. G, op.cit, p.48.

<sup>402</sup> Friedman. J. W, Oligopoly Theory, Cambridge Surveys of Economic Literature (Cambridge, University Press: 1983) p.1.

<sup>403</sup> Knickerbocker. F, Oligopolistic Reaction and Multinational Enterprise (Boston, Harvard University: 1973) p.4.

Friedman pointed out that according to Cournot Model, oligopoly can be approached from either of two directions: co-operative or non co-operative. The first is based on the assumption that oligopolists collude and that they will be able to make legally binding agreements. The second approach states that the oligopolists act independently of one another without colluding. However, each chooses the policy taking into consideration the behaviour expected from the other fellow oligopolists.<sup>404</sup>

Knickerbocker spoke of oligopolistic reaction and oligopolistic equilibrium, while considering the former as a partial explanation of foreign direct investment. But first, the following shows how he explained those two approaches.

Oligopolistic reaction: The oligopoly theory assumes that the acts of one firm will induce responses from fellow industry members, unlike the theory of pure competition. "This premise that firms are mutually interdependent means that the behaviour of firms in oligopolies will tend toward a pattern of action-reaction, move-countermove."<sup>405</sup>

Oligopolistic equilibrium: The rivalry among oligopolists can potentially deteriorate into mutually destructive competition. Knickerbocker believed that oligopolists are well aware of that fact. Overtime, he said, they may reach an understanding (explicit or implicit) to avoid intense rivalry. Instead, they would introduce order into the market. Each firm restrains its own aggressive behaviour with the expectation that rivals will exercise the same restraint.<sup>406</sup>

As was mentioned previously, Knickerbocker used the oligopolistic reaction as a partial explanation for FDI. His concern was to explain the motives behind US FDI, although he argued that this type of behaviour could not be the sole "or even principle explanation for why US firms have invested abroad". Oligopolistic reaction, according to Knickerbocker, must be

*"considered within a broad conceptual framework for two reasons. First, it is a description of essentially defensive firm behaviour. That is, if firm A makes a move, say investing abroad, then the concept of oligopolistic reaction tells us something about firm B, a rival to A, is likely to do. But, the concept of oligopolistic reaction does not explain why firm A moved in the first place."*<sup>407</sup>

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<sup>404</sup> Friedman. J, op.cit, p.21.

<sup>405</sup> Knickerbocker. F, op.cit, p.5.

<sup>406</sup> Ibid. p.7.

<sup>407</sup> Ibid. p.8.

A set of questions is to be answered to explain why oligopolistic moves and countermoves take the specific form of FDI, Knickerbocker suggested. These questions related to: the reason why US manufacturing industries have extended their activities abroad; why the bulk of such activities have taken place in industries with oligopolistic structures; and why, under oligopolistic conditions, firms have tended to match each other's moves of FDI.<sup>408</sup>

Letto-Gillies noted that Knickerbocker used Vernon's product cycle model as the basis for his own theory. He suggested that the fundamental inducement towards FDI is to be found in the analysis of the product cycle model. The US economic environment created opportunities for a continuous stream of labour-saving, high incomes products and generally for product development. American firms became skilled at 'pioneering' products. This gave them an advantage over foreign firms who could not match their skills and capabilities. However, the European markets that lagged behind the US ones were ready after a few years to receive the labour-saving, high-income products. These markets were served by exports and FDI followed. Licensing in some cases preceded FDI.<sup>409</sup> However, in producing abroad, US firms faced some disadvantages: a foreign environment; less preferential treatment by host governments compared to domestic firms; and the cost of gathering information, etc. These disadvantages were offset by the advantages of accumulated knowledge of managerial, marketing, and organisational skills, in addition to the lower cost of inputs in European countries. Tariff and non-tariff barriers and the fact that producing near the market has allowed firms to offer after-sales services and to adapt the product to the requirements of local customers, all contributed to the US firms' move overseas. Knickerbocker conclusion that for FDI "the product cycle model suggests that the fundamental consideration underlying such undertakings has been the desire of the US businessmen to exploit overseas the novel skills that their firms acquired in the course of satisfying US demand".<sup>410</sup>

There is therefore a link between product pioneering and the product life cycle, and oligopolistic structures, Letto-Gillies noted. He pointed out that firms that operate in fast-changing industries and are therefore involved in new products and new developments are also likely to experience various advantages. He anticipated that such

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<sup>408</sup> Letto-Gillies. G, op.cit, p.130.

<sup>409</sup> Ibid. p.130.

<sup>410</sup> Ibid. p.131.

advantages would lead to few producers and sellers, in the long term, as economies of scale eliminate smaller producers and act as entry barriers to new ones. However, such advantages are due to economies of scale only. Special skills accumulated in the course of developing and managing new products, their production and marketing are also extra advantages, he explained. "These skills help in both the domestic and foreign environments."<sup>411</sup>

The question remains to be answered as to why other firms engage in a defensive foreign investment, which leads to a "bandwagon effect". Investment abroad involves uncertainty, mainly with a newly launched product. A rival firm also faces uncertainty, however, it is more risky not to invest. "The risk is that the rival firm would gain considerable advantages from its aggressive move and then use the advantages against its rivals."<sup>412</sup> These advantages would include large-scale production, use of new production processes, and of vertical integration and general access to cheaper inputs. Marketing abroad should give advantages to the firm in both domestic and international market. Further aggressive moves can be built on the further organisational, managerial and marketing skills acquired from the first move. These advantages can change the competitive equilibrium, and gradually eliminate rivals. Other firms that would want to avoid such risks would follow up with their own FDI. "Ultimately, therefore, Knickerbocker explains the bunching up of FDI as the result of firms' defensive policies, which are designed to minimise risks in an oligopolistic environment."<sup>413</sup>

#### **4.3.4 Market Imperfections Theory**

The core of this theory is an assumption that a decision to undertake foreign direct investment is a move by the foreign firm to take advantage of certain capabilities not shared by local competitors. The first to talk about market imperfection and FDI were Hymer (in his PhD thesis of 1960), and Kindleberger, later in 1969. Caves mentioned it in 1974. Hymer noticed that frequently enterprises from different countries compete with each other because they sell in the same market or because they sell to other firms.

*"If the markets are imperfect, that is, if there is horizontal or bilateral monopoly or oligopoly, some form of collusion will be profitable. One form of collusion is to have*

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<sup>411</sup> Ietto-Gillies, G, op.cit, p. 131.

<sup>412</sup> Ibid.

<sup>413</sup> Ibid. p.132.

*the various enterprises owned and controlled by one firm. This is one motive for firms to control enterprises in foreign countries.*"<sup>414</sup>

To exploit an advantage within an imperfect market, a firm would be better off by moving in and exercising control over subsidiaries.

However, the profit of investing abroad should not be taken for granted as there are many risks involved. Kindleberger argues that a firm earns a higher return by investing abroad if it undertakes and overcomes the costs of operating in a different political and legal environment at a distance from its decision-making centre.<sup>415</sup> Higher return abroad is not sufficient as a motive for FDI, he considers, as capital markets would be a better way to achieve that.

*"If this were all (higher return), capital would move through organised capital markets rather than through firms that specialise in the production and distribution of goods. Capital markets specialise in moving capital, and under competitive conditions they are better at it than firms engaged in other lines."*<sup>416</sup>

A higher return than that of local firms in a foreign market should be the aim of firms investing abroad, he continues.

In operating abroad, a firm endures substantial extra costs. Kindleberger considers that it is not only the cost of travel, communication, and time lost in communicating information and decisions but also the cost of misunderstanding that leads to errors. An investing firm should have advantages to offset these disadvantages.

*"For a firm to undertake direct investment in a foreign country it must have an advantage over existing or potentially competitive firms in that country. If not, those firms, operating more cheaply in other respects because nearer to the locus of decision-making and without the filter of long-lines to distort communication, would put the intruder out of business."*<sup>417</sup>

Robock echoed the same arguments stressing that a firm faces a number of additional costs or disadvantages when entering a foreign country, as compared to a local firm.

*"The local firm would have an intimate knowledge of the economic, social, legal, and governmental environment. The firm can only acquire this knowledge at a cost. Furthermore, the foreign firm incurs foreign exchange risks, risks of possible errors*

<sup>414</sup> Hymer, S, op.cit, p.25.

<sup>415</sup> Kindleberger, C. P, American Business Abroad, Six Lectures on Direct Investment. (Yale University, 1969) p.11.

<sup>416</sup> Ibid.

*and misunderstandings from cross-cultural operations, and additional costs of operating at a distance.”<sup>418</sup>*

Kindleberger insists that in a perfect international market for products and factors of production there is no space for investment abroad. Local firms would be more qualified to serve their domestic markets.

*“In a world of a perfect competition for goods and factors, direct investment cannot exist. In these conditions, domestic firms would have an advantage over foreign firms in the proximity of their operations to their decision-making centres, so that no firm could survive in foreign operation. For direct investment to thrive there must be some imperfection in markets for goods or factors, including among the latter technology, or some interference in competition by government or by firms, which separates markets.”<sup>419</sup>*

On this same point, Caves pointed out that the large stock of knowledge about the language, laws and customs of its native land is an intangible capital that is productive in guiding the local firm toward profit-maximising decisions. The investing firm would have to acquire this information or “run the risk associated with action under relative ignorance”.<sup>420</sup> On this view, Caves continued: “the dice are loaded to some degree against the multinational firm, and its emergence thus demands an explanation”.<sup>421</sup> Caves provided the explanation himself. The firm, if successful, would have intangible capital, as well, in the form of patents, trademarks, or general knowledge about how to produce and distribute its products. “Being intangible, these assets can in some measure be moved from one national market to another, gaining rents in new locations without impairing the stock left in service at the home base.” He concluded that these advantages would offset the disadvantages resulting from the cost of collecting the intangible capital of information about the market.<sup>422</sup>

Thus, successful operations in a foreign country need some compensating advantages for the firm. “These advantages must be transferable within the enterprise and across

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<sup>417</sup> Kindleberger, C. P, *American Business Abroad...*, op.cit, p.12.

<sup>418</sup> Robock. S, *International business and multinational enterprises*. Fourth edition, (IRWIN, 1989) p.43.

<sup>418</sup> Ibid. p.45.

<sup>419</sup> Ibid. p.13.

<sup>420</sup> Caves. R, *International Trade, International Investment and Imperfect Markets*. (Princeton University, 1974) p.17.

<sup>421</sup> Ibid.

<sup>422</sup> Ibid. p.18.

distances. These advantages are referred to as *firm-specific* or *ownership-specific* factors.”<sup>423</sup> Robock argued that the competitive advantage of firms is explained by imperfections in markets for goods or factors of production.

*“In the theoretical world of perfect competition, firms produce homogeneous products and have equal access to all productive factors. In the more realistic world of imperfect competition, as explained by industrial organisation theory, firms acquire competitive advantages through product differentiation, brand names, special marketing skills, and restrictions to entry.”*

Other sources of competitive advantage, he adds, may be patented technology, internal or external economies of scale, or even differences in access to capital markets.<sup>424</sup>

Hymer argued that as firms are unequal in their ability to operate in particular industries, one with an advantage over the others in the production of a certain product would find it more profitable to extend its production process abroad. He noticed that the firm could also rent or sell its skills rather than undertake the production in the foreign country itself. “Which method it chooses depends largely on the degree of imperfection in the market for the skill. If the market is imperfect, the owner may not be able to appropriate fully the returns to the ability unless he controls its use.”<sup>425</sup>

Robock stated that the market imperfections model helps to identify the industries in which firms are likely to expand their direct operations either domestically or internationally. However, he argued, this model leaves many important questions unanswered.

*“Given the special advantage that permits the firm to invest abroad (i.e., the necessary condition), the model stops short of explaining why foreign production is the preferred means of exploiting the advantage (i.e., the sufficient condition). The firm’s advantage can also be exploited through exporting or licensing. Furthermore, the theory needs a time dimension in the sense that the advantage might erode and require disinvestments.”*<sup>426</sup>

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<sup>423</sup> Robock. S, op.cit, p.43.

<sup>424</sup> Ibid.

<sup>425</sup> Hymer. S, op.cit. p.26.

<sup>426</sup> Robock. S, op.cit. p.44.



#### **4.3.5 Internalisation Theory**

This extends the market imperfections approach by focusing on imperfections in intermediate-product markets rather than on final-product markets.<sup>427</sup> It assumes that the firm has a global horizon and it recognises that the enterprise needs a competitive advantage or a unique asset to expand. But the emphasis of the internalisation concept is on the motivations of the firm to extend its own direct operations rather than use external markets.<sup>428</sup> Robock stated that many intermediate-product markets, particularly for types of knowledge and expertise embodied in patents and human capital, are difficult to organise and costly to use. In such cases, the firm has an incentive to create internal markets whenever transactions can be carried out more efficiently within the firm than through external markets. This internalisation involves extending the direct operations of the firm bringing under common ownership and control the activities linked by the market.<sup>429</sup> The creation of an internal market, added Robock, permits the firm to transform an intangible piece of research into a valuable property specific to the firm. The firm can exploit its advantage in all available markets and still keep the use of information internal to the firm in order to recoup its initial expenditures on research and knowledge generation.

Rugman considered that internalisation is the result of both natural market imperfections and unnatural market imperfections.<sup>430</sup> An example of the first is the knowledge, or the know-how, that is owned by the firm and is very difficult to price. He described it as a public good, like a lighthouse beam, a public park, a road or a bridge. "The consumption of it by one party does not prevent consumption of it by other parties." Yet, he confirmed that those could be private once property rights are established. One method of creating property rights over knowledge is through internalisation, by creating a market within the firm.<sup>431</sup> On the other hand, unnatural market imperfections would include government-imposed tariffs on imports, foreign exchange control, and regulations on FDI.

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<sup>427</sup> Robock. S, op.cit. p.45

<sup>428</sup> Ibid.

<sup>429</sup> Ibid.

<sup>430</sup> Rugman. A, International business: Firm and Environment.. (McGraw-Hill: 3rd printing 1985) p.104.

<sup>431</sup> Ibid. p.107.

#### 4.3.6 Eclectic / O.I.L. Theory

In his introduction to foreign divestment theory, McDermott considered Dunning's Eclectic Model of International Production as being one of "the most comprehensive tools for analysing and explaining patterns of FDI".<sup>432</sup> Dunning's model stated that a firm's decision to engage in international production requires three conditions or advantages:

- the firm's possession of ownership-specific advantage. Rugman called this Firm-Specific Advantages in which a firm must possess a net ownership advantage *vis à vis* firms of other nationalities in serving particular markets (mainly foreign). These advantages are largely in the form of intangible assets which are, at least for a period of time, exclusive or specific to the firm possessing them;<sup>433</sup>
- when it is more profitable to internalise these advantages within the firm than sell them to independent parties; i.e. the firm possesses internalisation advantages. Rugman states that this secures the property rights over its firm-specific advantages, like knowledge, for example. He adds that this could be done through an extension of its own activities rather than by externalising them through contracts at arm's-length prices with independent firms. Moreover, alternatives to internalisation, such as licensing, management contracts, franchises, technical service agreements, turnkey projects, and subcontracts are not feasible methods of appropriating the firm-specific advantages;<sup>434</sup>
- when there are certain benefits to be gained by exploiting the advantages outside the home country market; i.e. the firm possesses location-specific advantages.<sup>435</sup> Rugman illustrated that if the conditions stated previously are satisfied, it must be profitable to the enterprise to locate abroad, that is, "to utilise these advantages with at least some factor inputs (including natural resources) outside its home country".<sup>436</sup> Otherwise, he added, foreign markets would be served entirely by exports and domestic markets by domestic production.

It is from the above-mentioned advantages that the O.I.L. framework was derived, a combination of the three factors: Ownership-specific advantages (O); Internalisation

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<sup>432</sup> McDermott, M, Multinationals: Foreign Divestment and Disclosure. (McGraw-Hill: 1989) p.10.

<sup>433</sup> Rugman, A, *op.cit.* p.117.

<sup>434</sup> *Ibid.*

<sup>435</sup> McDermott, M, *op.cit.* p.10.

advantages (I); and Location-specific advantages (L). Andersson considered those three advantages as cornerstones required for the undertaking of direct investment.<sup>437</sup>

Further illustration for what these advantages should comprise was provided by Rugman as follows:<sup>438</sup>

**Firm-Specific Advantages:** The range of advantages that can lead to FDI can be summarised as follows:

- 1- Propriety technology due to research and development activities;
- 2- Managerial, marketing, or other skills specific to the organisational function of the firm;
- 3- Product differentiation, trademarks, or brand names;
- 4- Large size, reflecting scale economies;
- 5- Large capital requirements for plants of the minimum efficient size.

**Internalisation Advantages:** The conditions that favour internalisation include:

- 1- High costs of making and enforcing contracts;
- 2- Buyer uncertainty about the value of the technology being sold;
- 3- A need to control the use or re-sale of the product;
- 4- Advantages to using price discrimination or cross-subsidisation.

**Country-Specific Advantages:** The location-specific advantages of the host country can include:

- 1- Natural resources;
- 2- Efficient and skilled low-cost labour force;
- 3- Trade barriers restricting imports.

#### **4.4 The usage of theories of FDI in the case of EU-private investments in Lebanon**

In assessing the motives for foreign direct investment in Lebanon, a combination of the theories of FDI is to be used rather than confining it to one particular theory. An analysis of these theories shows that any of them could be applicable to describe one or

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<sup>436</sup> Rugman. A, op.cit. p.118.

<sup>437</sup> Andersson.T, Multinational Investment In Developing Countries: A Study of Taxation and Nationalisation (London, Routledge: 1991) p. 24.

<sup>438</sup> Rugman. A, op.cit. p.119.

several cases of FDI, but none would be sufficient on its own to explain universally the motives for FDI. A quick critique of the content of the FDI theories previously mentioned justifies this approach.

The classical theory of direct investment focused mainly on the capital movement factor with the differences in interest rates between countries being the major motive behind any international capital movement. This movement was seen as an export and import of capital stimulated by the differences in interest rates. It could be argued that if capital would migrate from a low interest country to a higher interest country it is inevitable that capital would be invested in shares, bonds, or even be deposited in local banks to acquire higher interest. All these activities would still be considered within portfolio investment. However, the interest rate factor was considered as a motive for FDI activities simply due to differences in the cost of capital. This argument has suggested that a foreign firm might be able to afford to pay a higher price for a factory, for instance, than a local competitor, just because it had a lower discount rate. A strong exchange rate for the home country's currency would certainly be an advantage for investing abroad. Differences in interest rates affect FDI when borrowing is considered. Obviously, an investing firm would seek funding with the lowest interest possible. If borrowing at home were available at lower rates than the host country, this would lead to a transfer of capital from the home country to the investment destination. However, it is not the higher interest rate behind this capital movement. The capital is motivated by the firm's decision to invest in a particular economic activity in the host country. This might lead to the question: which motive comes first, the opportunity to invest or the cheap borrowing at home? Clearly, a firm would not consider borrowing for the sake of it only. Unless there is a projected role for the loan, a firm does not need to consider borrowing. Therefore, the firm's intention to exploit an opportunity for profitable investment abroad encouraged it to seek cheaper funding. Besides, as lower interest rates are targeted while seeking funding, capital then does not necessarily have to come from the firm's home country. Ohlin himself admitted this fact. He as well noticed that a firm might decide to establish production abroad due to barriers which obstruct international trade. This means that differences in interest rates are not necessarily the reason for all international capital movements, and certainly not for direct investment in foreign countries. Indeed, this argument that highlighted the role of cost of capital in motivating FDI activities is the old explanation for international capital movement.

However, as Graham and Krugman have noticed, the argument has shifted towards studying the industrial-organisation considerations rather than the cost of capital, since the early work of Hymer in 1959.<sup>439</sup>

Suggesting that profit maximisation is the motive for international direct investment, as Czinkota claimed, contains a great deal of generalisation. Certainly, profit maximisation is the aim of the majority of foreign direct investment activities, as well as domestic investment. Yet, a substantial number of foreign activities of a firm would be to protect an existing share in the foreign market, which might be threatened by competition from domestic producers or other foreign exporters. This argument was adopted by most of the subsequent theories of FDI. Another generalisation is to assume that productive resources will seek out the highest return. This is the essence of the classical theory, according to Czinkota. Obviously, a higher return is a target of a firm's activities, and this could be applied to domestic activities, as well as to overseas ones. However, the theory offers no explanation of why there should be a higher return for investments abroad. A justification would lie within the fact that this theory did not distinguish between direct and portfolio investments. Productive resources should then mean capital, while higher return should be obtained by seeking the highest interest rates. The classical theory is not adequate in itself to explain foreign direct investment activities due to the gaps that it does not try to fill. However, it should be taken into consideration that this theory was introduced before foreign direct investment was discussed as a separate activity. It does not provide a good basis to examine contemporary FDI activities and the motives behind it. Thus, this theory will not be used extensively in this research.

Moving to the International Product Life Cycle Theory, this was introduced by Raymond Vernon, and is derived from a theory of international trade. So, like the Classical Theory, it originates from another theory. However, it focuses on the motives for overseas investments from the product angle rather than the interests of capital. It is one of the earlier theories that addressed FDI without mixing it with portfolio investment. This theory stipulates that investment abroad would be a subsequent step to trade. A producing company in a developed country invents a new product for the local market; introduces it to foreign markets; establishes production abroad to be close to the

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<sup>439</sup> Graham & Krugman.. op.cit. p.28.

new markets and avoid trade barriers; and then, the low cost of production abroad will lead to a reversed export from the subsidiary abroad to the home market. Therefore, FDI has to be always a stage following international trade and never a precedent.

This theory was used to understand the motives behind the US firms' decision to invest abroad. A comprehensive explanation is in fact provided by this theory to understand why many US firms decided to extend their production procedures abroad. The same could be applied to non-US firms in other developed countries. However, the international product life cycle theory does not provide a comprehensive framework for the understanding of why companies decide to engage in FDI. The focus on the product life perspective eliminates other aspects of investment within international production. A firm does not necessarily have to be involved in successful trade with a country in order to decide to invest there. Many firms decide to invest in buying a substantial share in companies abroad, merge with or buy out companies in foreign countries for reasons that are not related to the life cycle of their own products. It could be merely because that company has the potential for success and achieving high profit. Apart from the fact that it would be well established in the country, and has the knowledge of the market. Thus, this theory will be used in this research but not solely.

The Monopolistic-Oligopolistic Advantage theory highlights the "exploitable factor" possessed by the firm, which could encourage it to invest abroad. However, as far as the oligopolistic factor is concerned, Kinckerbocker pointed that it plays a role in motivating firms to invest abroad only when another rivalry company preceded it in establishing production abroad. He considered the second firm's behaviour as an oligopolistic reaction. To understand the first move of FDI he depended on the product life cycle theory. Therefore, those two theories are related in a subsequent way. And, as the theory of product life cycle will be used in studying the case of European direct investments in Lebanon, then the oligopolistic reaction approach is applicable as well. It is a very focused approach that does not serve as an explanation for the majority of FDI activities, but it would still justify many other decisions to invest abroad. This theory will be used to investigate whether some EU firms' moves into Lebanon were an oligopolistic reaction.

The Market Imperfections Theory agrees with the monopolistic-oligopolistic approach's focus on the "exploitable factor". It stresses however, that if the firm does not own an

advantage over local companies than there should be no motive for FDI. Such advantages and disadvantages between firms create imperfection in markets that could be exploited by advantageous firms whether domestically or internationally. Obviously, firms in developed countries have the advantage of access to research facilities and capital. Moreover, they have the marketing skills and brand names for which there is a strong demand for in developing countries. Thus, they already have an advantage when compared to local companies. But, as the theory suggests, these advantages need to compensate for the costs that a firm would endure while entering a market of which it had a very little knowledge. Clearly, if a firm was profiting from exporting its products to a particular market, this should not necessarily mean that moving production to a proxy location should bring more profit.

This theory does provide a useful explanation that helps when examining the motives behind FDI. Despite Robocks reservations about the gaps in this theory,<sup>440</sup> it is justifiable to say that if markets were perfect with all companies having access to necessary factors of production, then FDI would not be necessary. It explains numerous moves by many US companies to invest abroad, as with other companies from other developed countries in Europe, and Japan. The approach of market imperfections will be taken into consideration in this thesis, but still it cannot be used solely in explaining the reason behind every firm's decision to invest overseas. The 'exploitable advantage' which is firm-specific is essential, but a company would be looking for other advantages that can be acquired by investing abroad. These advantages could result from becoming close to natural resources, or having abundance of skilled and/or cheap labour. These are vital to any production activity while the market imperfections approach does not address them at all. Moreover, this theory does not clarify the stage when a firm would decide to shift from serving a particular market through exports to extending its production arm to the market itself. If exports were serving the market adequately then there would be no reason to take the risk of setting up a production plant closer to it. The success of the firm's exports would be due to the quality of the product combined with its brand name and price. Therefore, another serious motive must have convinced the firm that moving production facilities to the remote market should be more profitable. This theory does not explain such reason.

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<sup>440</sup> These were mentioned earlier while discussing the theory of market imperfection. (Confinement to exports or licensing, and the time dimension).

The Internalisation theory, on the other hand, follows up what the Market Imperfections theory started. However, the focus in this theory is not on the final product. It is rather concerned with the knowledge and expertise that a firm owns. The multinational company acquires knowledge through the research and development (R&D) conducted at home. It also develops expertise in producing and marketing. As the firm considers these advantages exclusive, and while the decision to produce abroad was taken, FDI would be preferred by the firm as opposed to franchising or licensing. The rationale is that the firm wants to keep its patent and exclusive knowledge internal without moving it to another company. In other words, this theory is concerned with the intangible assets that the company owns embodied mainly in knowledge. It is not easy to price knowledge, and most of the time the company would want to keep it within. That is why a subsidiary would be preferable by which the firm establishes its own internal market where patents would be flowing between the headquarters and subsidiaries and vice versa without leaking to outsiders.

Noticeably, all theories of the international organisation mentioned previously seem to be flowing in a subsequent context, and to a certain extent complement each other. Each filled some gaps in every precedent theory. The product life cycle theory decided that production abroad is part of the product life that succeeds exports. The oligopolistic reaction decided that rival companies would follow the leading company fearing to miss an opportunity for profit, or even an existing market. Meanwhile, the market imperfection theory said that a firm would not move abroad unless its products were successful and there was a chance to exploit its advantages over local competitors. The internalisation theory's contribution to this discussion is that a company establishes production abroad not only because the product is successful, but also because the know-how should stay within the company.

Hereafter comes Dunning's Eclectic Theory or his O.I.L framework for FDI. It is as if Dunning thought: "All what was said is applicable but needs to be put together, and combined with what was not said". Thus his O.I.L framework brought together ownership-advantage with the internalisation-advantage, but then added to it what was always missing before, the location-advantage. Certainly, the firm needs to own an advantage over domestic firms to decide to invest abroad, and that would very likely be an intangible asset. Obviously, it is better to protect these assets rather than



externalising them. Therefore, internalisation is a perfect way to secure the firm's property rights. However, this was not enough for Dunning to motivate a firm to engage in FDI. He decided that locating the business abroad should be instigated by potential benefits from the location itself. He was referring to proximity to natural resources, skilled and/or cheap labour, and the ability to avoid trade barriers. In effect, Dunning found a major loophole in the previous theories, which left the question of the motives of FDI slightly vague. The decision to switch from exporting to producing abroad was still unclear. Recognising that a firm would benefit from market imperfections is not enough. Market imperfections could be exploited through trade as well. Meanwhile, internalisation is a measure to be considered after making the decision to produce abroad, after examining whether licensing or franchising are as suitable to protect the firm's specific advantages. So, the firm's move must have been triggered by other incentives coming from the location itself, i.e. some factors of production would be available at a competitive cost.

#### **4.5 Conclusion**

These are the theories that are to be used in this research. They have stipulated a wide range of criteria for the motives behind a firm's move to produce in a particular foreign country. The next step is to highlight these motives to examine how applicable they are for the case of European businesses in Lebanon. The motives to be applied suggest that a firm would engage in foreign direct investment for one of the following reasons or circumstances:

- To benefit from the differences in interest rates between countries;
- It is a stage in the product life cycle when a firm decides to replace exports by production abroad to achieve competitiveness by reducing the cost;
- To exploit a specific advantage over domestic companies in the foreign market;
- An oligopolistic reaction following another rivalry firm's decision to produce abroad;
- If market imperfections worked to the benefit of the firm to compensate for its disadvantages in a foreign market;
- When the firm is unwilling to extend its patent knowledge of production to other firms abroad, but still wants to produce there;

- When the company realises a number of advantages in localising production in a particular foreign country, i.e. access to cheaper factors of production, or avoiding trade barriers and transport cost.

This set of criteria will be used to examine the presence of EU-private businesses operating in Lebanon during the reconstruction period. Two questions need to be answered. Firstly, to what extent is EU FDI present in the Lebanese economy and, secondly, how can we account for that presence, or indeed the absence of such a presence. The following chapter provides a survey of European business activity in Lebanon in the reconstruction period. It shows that such activity included trade, franchising, representation, contracting and FDI. In the later chapters, I will assess the size of EU-FDI activity and the factors contributing to its presence or absence.

## **Chapter Five: Overview of European Businesses in Lebanon**

### **5.1 Introduction**

The aim of this chapter is to establish a profile of EU private business activity in Lebanon. This will include assessing its presence compared to companies from other nationalities; determining the sectors of business that EU firms are involved in; and the size of business presence of each EU member state. These assessments will help in identifying the main interests of EU firms in Lebanon, and to what limit Lebanon represents an attractive destination for EU firms. Ultimately, the aim is to identify the EU firms that are involved in FDI activities.

Once we start discussing the issue of foreign direct investments in Lebanon in general, we have to take into consideration the immense difficulties in seeking information and figures that could reflect the size of FDI in Lebanon, and sectors that it is channeled into. These problems arise mainly from the fact that statistics provided by the Lebanese government are quite rare. Indeed, figures on FDI are not provided by the government. The only figures that were available were produced by UNCTAD and very limited Arab sources concerned with inter-Arab investments. Even these figures differ remarkably. Looking at available material on foreign companies registered with the Ministry of Economy and Trade, the same item of information varies from one list to another. The same problem was faced throughout this research when it comes to statistics on Lebanon. This makes the results of any calculations in the analysis approximate rather than absolutely accurate.

### **5.2 Foreign direct investments in Lebanon**

EU-private direct investments in Lebanon should be looked at within the context of total FDI inflows into the country. The limited figures available on FDI in Lebanon have shown that it has increased significantly since the beginning of the reconstruction process. The figures provided by UNCTAD indicate that FDI amounted to \$US 4 m in 1992 but reached \$US 35 m in 1995. The table below shows how these figures developed.

**Table 5.1 Increase in FDI inflows into Lebanon after the beginning of reconstruction**

Year	1985/1990 (average annually)	1991	1992	1993	1994	1995	1996a
FDI	4	2	4	6	7	35	30

a : estimates

Source: *World Investment Report* (New York: UNCTAD, 1997) p.306.

Clearly, FDI inflows increased gradually after the end of the civil war in 1991 till the beginning of the reconstruction process at the end of 1993. The year 1995, according to these figures, witnessed a huge hike as FDI inflows increased by five times the figures of the year before. That could be attributed to the upsurge in the reconstruction process.

However, these figures are not clear when it comes to examining the basis used to assess FDI inflows into the country. In fact, these figures seem to have excluded a significant amount of FDI. The UNCTAD analysis states that direct investment abroad is estimated on the basis of financial transactions between parent-firms and their foreign affiliates in the form of equity or loans, or earnings of affiliates that are not repatriated.<sup>441</sup> This analysis emphasises that foreign affiliates can be financed from other financial resources, like loans obtained by parent-firms or foreign affiliates from commercial financial institutions in host or third countries, funds raised by parent-firms or foreign affiliates in host or third country capital markets, and loans received by foreign affiliates from home country financial institutions. Funds raised from these other sources seem to be apparent, the UNCTAD analysis affirms, when examining how the total assets of majority-owned foreign affiliates of US-based TNCs are financed. In 1994, parent-firms financed slightly more than one-third of the value of the total assets of their foreign affiliates including the parent-firms' share of their affiliates retained earnings. Meanwhile, most of these assets were financed by debt instruments coming partly from financial institution in the country of the foreign affiliate.<sup>442</sup>

<sup>441</sup> World Investment Report, (New York: UNCTAD,1997) p.25.

Thus, the UNCTAD figures do not reflect the real size of FDI in Lebanon. These figures include only the capital transfers from a parent TNC to its affiliate in Lebanon. As it has been shown, most of these TNCs raise funds outside their home countries, and are most likely to get it from a third country. However, the figures are still low and vague. Many companies have representative offices in foreign countries. In the case of Lebanon these are quite few. The budgets allocated to these offices are not clearly defined as being FDI or not. Foreign investments in property do not seem to be clearly identified. The figure of US\$ 35 m for FDI in Lebanon in 1995 could easily be accounted for by the purchase of a single plot of land in Beirut. This figure is either completely unrepresentative or reflects a poor foreign interest in investing in Lebanon. This matter shall be addressed later in this chapter when assessing the presence of foreign companies in Lebanon.

Another source of figures on foreign investments in Lebanon is inter-Arab investment statistics.<sup>443</sup> There is a striking difference between those figures and UNCTAD ones. As UNCTAD estimated FDI inflows into Lebanon to be US\$ 30 m, the other source shows that Lebanon's share of inter-Arab investments only was US\$ 250 m in the same year. Furthermore, it says that it increased up to US\$ 312 m in 1997. Out of a total US\$ 1.59 bn total of inter-Arab investments, Lebanon's share was 19.6 per cent. It came third after Egypt US\$ 532 m , and Syria US\$ 328 m. While inter-Arab investments decreased totally from US\$ 2.09 bn in 1996 by 23.9 per cent, Lebanon's share increased by 7.6 per cent.<sup>444</sup>

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<sup>442</sup> World Investment Report, (New York: UNCTAD, 1997) p.25.

<sup>443</sup> *Taghir manakh al-issstissmar fi a-duwal al-'arabiah 1997* (Report on investment climate in Arab states 1997). Produced by *al-muassassah al-arabiah li-daman al-issstissmar* (Arab Establishment for Investment Guarantees) 1997. p.37.

<sup>444</sup> Ibid.

**Table 5.2 Inter-Arab investments (US\$ million)**

Country	1996	1997	Percentage in 1997
Egypt		532	33.5 %
Syria		328	20.6 %
Lebanon	250	312	19.6 %
Total	2,090	1,590	23.9 % decrease

Source: *Taqrir manakh al-ississmar fi a-duwal al-'aabiah* (1997) p.37.

The margin of difference between figures is conspicuous. If UNCTAD estimates were correct, this means that inter-Arab investments into Lebanon were 8 times the size of FDI in Lebanon. This cannot be normal, as Arab investments should still be considered foreign investments. One reason that the author thinks could explain the difference is that inter-Arab investments did not specify the type of investments. It did not call it direct investments, for instance. This could lead to a suspicion that it might have included portfolio investments as well. However, if FDI figures were confined to transactions between parent-firms and their affiliates in Lebanon, then this could reduce the share of Arab investments within that figures to a minimum, as very few Arab investments in Lebanon could be included under that category. Although the author could not find specific data to support this argument, it is commonly known that Arab investments mostly come from individual businessmen. Indeed, the rise in Arab investments in Lebanon, in 1997, was caused by the purchase of a Lebanese bank (Crédit Libanais) by a group of Gulf businessmen (the figure was around US\$ 60 m), in addition to other deals in different banks.<sup>445</sup> The last figures available on FDI in Lebanon are the estimates of the EIU reports that emphasised the fact that figures of FDI, and indeed, portfolio investments, are difficult to obtain. It echoed some estimates in 1997 that it was around US\$ 1 bn per annum.<sup>446</sup> In another report, the EIU shows how unreliable are the figures of FDI in Lebanon: the World Bank, in one publication put net inflows at US\$ 2.55 bn in 1996, while in another publication it put it at US\$ 80

<sup>445</sup> *ibid.* p.194.

<sup>446</sup> EIU, Country profile, Lebanon, 1997-98. p. 37.

m. The EIU thinks that the latter figure is more accurate. Still, this figure shows a stunning difference with the estimates it echoed in its report in 1997.<sup>447</sup>

Within this uncertainty about figures of FDI in Lebanon, it would be an immensely difficult, even impossible, task to assess accurately the size of FDI in general, and EU-private investments, in particular. However, the way to get around these problems is by assessing the presence of foreign companies in Lebanon, including EU firms, and examining the type of their activities in Lebanon. That will show relatively the extent of EU firms presence in Lebanon. The available data provided the names and numbers of these firms but no details of their capitalisation. Therefore, their numbers will judge the presence of these firms. Moreover, the involvement of EU firms in the reconstruction process will be examined to assess their share of business generated by the urgent need to reconstruct the country.

### **5.3 Foreign firms in the post-civil war period (1990-93)**

The previous chapters showed how most of foreign companies which operated in Lebanon before the civil war had to cease their activities and leave the country. European companies were among these companies that had to minimise their presence in Lebanon.

Some foreign companies resumed their activities in Lebanon when peace was restored. Foreign businesses seemed to have realised that a country coming out of a devastating civil war must represent huge opportunities for business, generated by the need to reconstruct in the aftermath period. However, the number of companies registered in Lebanon between 1990-92 shows that foreign business interests were still minimal. Only 15 foreign firms were registered in Lebanon during that period, according to the lists of the Ministry of Trade and Economy. This could be attributed to the precarious state of the Lebanese economy that was revealed mostly in a very unstable exchange rate, high inflation rate, and vague fiscal policies. The instability on the economic scene was accompanied by political uncertainty. The government was in the process of extending its control over most of the Lebanese territories while first parliamentary elections after

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<sup>447</sup> EIU, *Country Profile, Lebanon*, 1998-99, p.31.

the war were yet to be held. Such uncertainties, in any similar case, would maximise the risk factor in the decision-making process of any business considering launching new operation. That could certainly be the case of foreign businesses in Lebanon between 1990-1993.

The list of foreign companies that registered with the Ministry of Commerce and Economy is very short indeed. Only 15 companies came to Lebanon during that 'interim' period between war and reconstruction. These represented countries from Europe, Arab world, and others.

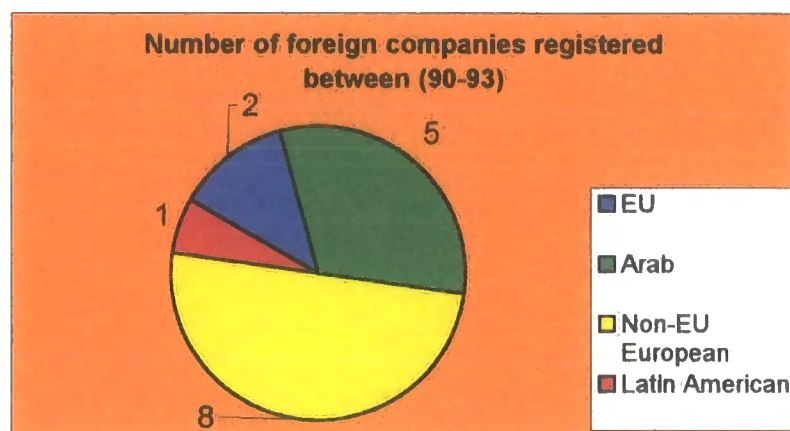
**Table 5.3 List of foreign firms registered between (1990-93)**

Co No	Company Name	Business/sector	Date of registration	Country
1	East West Trade Technologies LTD	Trade	8-11-90	Britain
2	Kassion	Construction of Roads	10-7-91	Syria
3	a-Tanmiyah lil-awrak al-malivah	Finance	17-7-91	Jordan
4	Emirates Airlines	Airline	14-8-91	UAE
5	Majdonarodnaya Knefa	Media services	7-8-91	Russia
6	al-watinyah lil-khadamat al-milahivah	Maritime agency	26-9-91	Jordan
7	Halah Trade	Trade	25-1-92	Panama
8	Middle East sanitary Marketing & Agencies	General trade		Cyprus
9	a-sharikah al-amah lil-binaa	Construction of Roads	17-3-92	Syria
10	Czech Airlines	Airline	17-3-92	Czechoslovakia
11	Integro advanced Computer Systems	IT	1-8-92	France
12	Turkish Airlines	Airline	21-9-92	Turkey
13	United Marine Holdings A.G	Trade & Finance operations	9-11-92	Liechtenstein
14	Golf Agencies Company Ltd	Trade & Finance operations	9-11-92	Liechtenstein
15	International Shipping Agencies Ltd	Trade & finance operations	9-11-92	Liechtenstein

*Source: Compiled by the author from lists provided by the Ministry of Economy and Trade in Lebanon.*



**Chart 5.1**

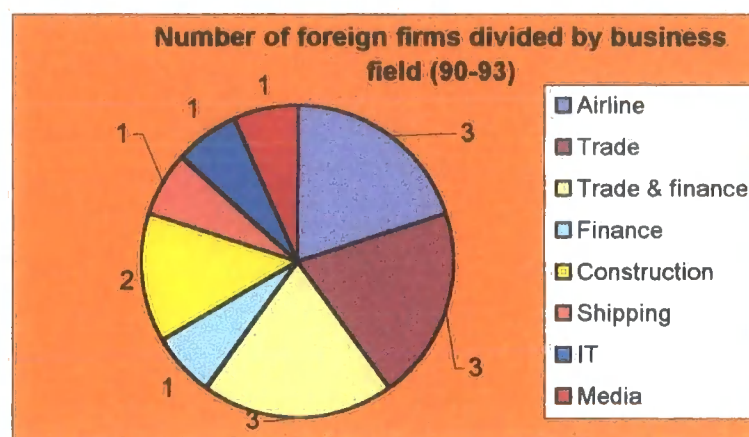


*Source: Derived by the author from lists of the Ministry of Economy and Trade.*

### **5.3.1 Fields of interest for foreign firms (90-93)**

The activities of foreign firms registered in Lebanon during this particular period did not show a trend towards a particular sector. Indeed, interests were diversified into various activities of mainly services and took the shape of representative offices. Some of the airliners that had stopped flying to Beirut during the war decided to come back. Other trade companies also probably felt it was safe enough to open a representative office to benefit from the ever-flourishing trade in Lebanon (the huge dependence of Lebanon on imports always created opportunities for trade even during the worst times of the civil war). It is noticeable that two Syrian contractors companies were registered during that period while no other foreign firm involved in such a field of business did so. The fact is that those two companies were involved in a few projects the government had undertaken to rehabilitate existing roads networks. The scale of business during that period was still very little. Thus, there were no incentives for foreign firms.

**Chart 5.2**



*Source: Compiled by the author from the lists of the Ministry of Economy and Trade.*

#### **5.4 Reconstruction process charms foreign firms**

The commencement of the reconstruction process was accompanied by an influx of foreign companies into Lebanon. This process was effectively kicked-started after Prime Minister Rafiq Hariri took office at the end of 1992. The country had had its first parliamentary elections by then and it was time to start rebuilding the economy and the devastated infrastructure. It was believed that the unstable economic situation needed the strength of Mr Hariri's financial position to navigate towards stability and then prosperity. A billionaire Lebanese-Saudi businessman, Hariri came with an agenda, with the start of the reconstruction process on top of its priorities. The first achievement of his government was the stabilisation, and later gradual evaluation, of the Lebanese pound exchange rate. Inflation was brought under control as well. The situation changed immensely from what it used to be before Hariri. It could be argued that the presence of Hariri encouraged businesses to get moving, and capital inflows to increase, given what was said about his position. He seemed to help in rebuilding the trust in the Lebanese economy by his presence at the top of the government. He commenced his reconstruction plan according to which the government was to rebuild the devastated physical infrastructure of the country. The plan was inevitably a state-led process.

However, given the fact that the public sector in Lebanon is very small and does not involve any industries, apart from utilities, private firms were needed to do the business while the government would meet the cost. It was the chance for private businesses, local and foreign, to compete for the jobs. This explains the surge in the number of foreign firms being registered in Lebanon since 1993 (see table). European firms were noticeably present in Lebanon again. Indeed, firms from EU member states were a majority among incoming foreign companies. The following table helps describing the picture of foreign business in Lebanon upon the beginning of the reconstruction process.

**Table 5.4 Foreign companies registered in Lebanon after 1993**

Co No	Company Name	Business/Sector	Country
1	Euroshipping	maritime agency	Italy
2	Sommer S.A	Promotions (Trade)	France
3	Hyundai Engineering & Contracting Ltd	Construction (contracting)	S. Korea
4	Brown & Wilson Europe	Tobacco Industry	Belgium
5	Nour Consult Int	Engineering contracting, industrial services	Norway
6	Archicenter Associates Ltd		Britain
7	Siemens S.A	Telecom, electricity (contracting)	Germany
8	Clemessy	Electricity rehabilitation (contracting)	France
9	Philips Medical Systems Int B.V	Construction	Netherlands
10	Credit Commercial De France	Finance (Representative office)	France
11	Bouygues	Trade, Import & export, electricity (Contracting)	France
12	a-shahed Publishing Ltd	Publishing	Cyprus
13	Ingersol Dressor Pump Services S.A.R.L	Industrial equipments (supplier)	switzerland
14	Kukdong for Engineering and Construction	construction	Korea
15	Emeco S.A.L	Trade	Germany
16	Maytag Int. Inc.	Trade	US
17	UBAF Bank Ltd	Finance (Banking)	Britain
18	Covec		China
19	Alcatel Contracting	Telecom. (Contracting)	France
20	al-asmak al-kuwaitiah al-mutahidah	Trade	Kuwait
21	Topcon Corporation	Marketing	Japan

22	Societa Italiana Reti Telefoniche Interubane Sirti	Construction (Telecom networks)	Italy
23	Trafalgar House construction Int. Ltd	construction (contracting)	Britain
24	Digital Engineering Ltd	Engineering consultants	Ireland
25	C&C construction Company Ltd	Construction (contracting)	Nigeria
26	Itochu Corporation	Trade (Imp & Exp)	Japan
27	Internationale Nederlanden Bank N.V (ING Bank)	Finance (Banking & Insurance Refunds)	Netherlands
28	Ciba-Geigy Services Ltd	Medication company	Switzerland
29	Hochtief A.G	Construction (contracting)	Germany
30	Sodexho Int. S.A.	Hospitality (catering services)	Panama
31	Gulf international Bank	Finance (banking)	Bahrain
32	Bauer Spezialtiefbau GMBH.	Construction	Germany
33	Pepsi Cola Int. Ltd	Representative office	Bermuda
34	Robert Fleming Holding Ltd	Finance (Investment)	Britain
35	Alcatel Telespace	Production of electronics (supplier)	France
36	Adidas Sarragan France	Production, exp & imp of sports wear	France
37	3 M Gulf Ltd	Trade	Cyprus
38	Hubei Provincial Int. Trade Cooperation	Trade (Exp & Imp)	china
39	Paribas Ltd	Finance (Banking & investment)	France
40	a-Sharikah al-qawmiyah lil-tashied wal t'amier	Construction (contracting)	Egypt
41	Conspel construction Specialist Ltd	Engineering	Liechtenstein
42	N.V.Upjhon S.A.	Pharmaceutical products	Belgium
43	S.A. Monroe Europe N.V.	Representative office	Belgium
44	Elie Lilly (Suisse) S.A.	Scientific & technical aid	Switzerland
45	Marriott Int. Hotels Inc.	Hospitality (Hotel)	US
46	Dyckerhoff & Widmann Aktiengesellschaft	Contracting & construction	Germany
47	Commerz Bank	Finance (Research in Economy and finance)	Germany
48	European Gas Turbines	Research in Turbine gas, (contracting)	France
49	I.C.A.R. Construzioni Generali S.P.A.	Contracting & construction	Italy
50	Polysius S.A.	Production, sales, maintainance of products	France
51	Citi bank N.a	Finance (Banking)	US
52	Malaysian Airline System Berhad	Marketing arial transportation& services (Airline)	Malaysia

53	Smithkline Beecham Marketing & technical Services	Marketing office (Pharmaceutical products)	Britain
54	ETDE	Consultancy, Electricity, Gas, telecom. (contracting)	France
55	Christiani & Nielson Ltd	General trade, contracting	Britain
56	Ansaldo-Energia Spa	construction of Electricity plants (contracting)	Italy
57	Engineerig Business Development, Inc	engineering, contracting, general trade	US
58	Berliner Bank Aktiengesellschaft	Finance. Representative office	Germany
59	a-sharikah a Saudiah lil-abhass wa nasher	Pharmaceutical	Saudi Arabia
60	C.A.T. Int. Ltd	contracting	Channel Islands Britain
61	Mother Cat Ltd	Contracting	Channel Islands Britain
62	sharikat markaz al-ma'adin a-sin'aiyah (metal ind)	Trade	Kuwait
63	S.I.F. Bachy	Works of drilling, pumping and excavation	France
64	Shenfu Real Estate Development Co. Ltd	Trade (enhance trading between China & Lebanon)	China
65	Klochner Steel Middle East FZE	Representative office .Promotion of steel sales	Dubai - UAE
66	Reuters Ltd	News agency	Britain
67	ABB Management (Middle east & North Africa)Ltd	representative office	Switzerland
68	Club Flipper Turizmve Insaat Yatirimlari Sanayive	Housing projects	Turkey
69	Republic National Bank of Newyork	Representative office	US
70	Abed Ishak Abed al Hamza & Co	Extract, manufacture and export marble	Jordan
71	Dames and Moore, INC	Engineering (other)	US
72	Maraji for commerce Ltd	Trade (agricultural products, fertilizers,	Saudi Arabia
73	Tecsa Technical Sales S.A.	Representative office (trade in ind. Equipments	Panama
74	Kuwait Airlines Establishment	Airline	Kuwait
75	Compania De Constructii Bucuresti S.A. Company	Construction	Romania
76	Industrial Saudi Arabia Company for Windows	Production of doors and windows	Saudi Arabia
77	Nizar Assaad & Ghassan Mouhanna Ets. For contracti	Construction (contracting)	Syria
78	Cowi Consulting Engineers Planners A.S.	Engineering consultants	Denmark
79	The Bank of Nova Scotia - Canada	Finance (Banking)	Canada
80	Trade Circle Int. (UK) Ltd	Investments in trade, industry and	Britain

		finance	
81	First Resort	Trade (Marketing of Egyptain& foreign products)	Egypt
82	Archirodon Construction (overseas) Co. S.A.	Engineering, construction, designing	Panama
83	Banco De Ibero America S.A.	Representative office Finance (Banking)	Panama
84	Alhamma for Development and Commercial Agencies	Trade	Saudi Arabia
85	GEC/Alsthom - Société D'études et de Montage	Industrial studies	France
86	Etablissements Jean Graniou S.A.	Electrics and telecom installations	France
87	Sagem S.A.	Representative office (consultancy in industries)	France
88	International Turnkey Systems	Promotion of computer systems	Kuwait
89	Guinier S.A.	Investment, construction, electricity	France
90	Abbott Laboratories S.A.	Pharmaceutical services	Switzerland
91	Martwell Middle East Ltd	Trade & services	Jersey - Channel Islands - Britain
92	Joseph Constantin Inc agir sous le nom de Melkart	Trade (fashion)	Canada
93	Brown and Root Projects Ltd	Engineering, Trade (Exp& Imp)	Britain
94	Duro Dakovic Montaza L.L.	Construction & investment	Croatia
95	St. FA Energy Telecommunication Industry& Trade In	Contracting (electricity intallation for public sector projects)	Turkey
96	Intrecanales Y Tavora s.n.	Construction	Spain
97	Joint-Stock Company Corporation Khortitsa	Trade , exp-imp	Ukraine
98	Bouygues Offshore S.A.	Contracting (tech. Studies&Work for Solidere	France
99	BAT (UK and Export) Ltd	Investment, technical services	Britain
100	SDEM Enterprises S.A.	Industrial studies	France
101	Rendel Palmer & Tritton Ltd	Contracting, engineering consultants	Britain
102	Commercializadora Romana De Costa Rica S.A.	Promotion, trade	Italy
103	Societe de Commercialisation Assistance et Realisation pour L'Industrie de Batiment	Engineering, construction, planning	France
104	a-saudiah al-hadissa li-sina'at al-ma'aden...	Production of zinc sticks for wiring	S. Arabia
105	Ed.Zublin A G	Contracting	Germany
106	Societe Francaise pour le Commerce Exterieur (SOFRACE)	Exp-Imp of sewing products	France
107	Marina Contractors Inc.	Contracting, engineering (touristic sites)	US
108	Schneider Electric S.A.	Studies & investment (electricity)	France

109	Gestion Cajiltee	Trade	Canada
110	Beverage Services Ltd	Marketing, sales, technical services	Bermuda
111	Henny Penny Corporation	Real estate , administration	US
112	Sony Gulf FZE	Trade in electronics	Reg. in UAE
113	Husain Abou Taa & sons	Contracting (excavation of water)	Jordan
114	Compagnie D'Entreprises CFE	Contracting-investments in railways & roads	Belgium
115	IMS Information Medical Statistics AG	Computing (esp. in pharmaceuticals)	Switzerland
116	Capital Trust S.A.	Finance (Investment)	Luxembourg
117	ICO Global Communications Holdings B.V.	Telecom.	Netherlands
118	Ferrostaal A.G	Trade	Germany
119	Rabot Dutilleul Enterprise S.A	Contracting (construction of Lebanese University)	France
120	United Distillers P.L.C.	Representative office	Britain
121	Lafrage S.A.	Management of Industrial, and financial cooperation	France
122	Thyssen Hunnbeck GMBH	Construction equipments	Germany
123	Levant Maritime Services S.A.R.L	Transport	Romania
124	Cable News Int. Inc	News agency	US
125	Dead Sea Industrial Establishment	Manufacturing Sodium Chloride pills for water	Jordan
126	Compania de Agroquimicos. S. A.	Manufacturing & selling chemical & agricultural products	Spain
127	Ayobco for construction	Contracting construction	Egypt
128	Intrafor	Realisation de travaux de fondation	France
129	Herve S.A.	Construction	France
130	Biochemie GMBH	manufacturing & selling of chemical products	Austria
131	Charalambos Venetis Bakery-Confectionery...	manufacturing & distribution of bread and sweets	Greece
132	Groupe Actif S.A.	Consultancy (financial, legal, accounting, and IT services)	France
133	Imation International. B.V.	Trade (Exp- Imp)	Netherlands
134	Hamad Abdulah a-Zamil& Bros	Trade (medical & pharmaceutical equipments)	
135	Arsana S.R.O	Achat des marchandise pour les revendre	Czechoslovakia
136	Armenian Airlines Co.	Airlines	Armenia
137	Opere Pubbliche SPA	Contracting (construction)	Italy
138	Fortune Consultants Group Inc	Finance (Investment)	Britain
139	Arcif S.A.	Water projects & improvement of	Romania

		soil	
140	Homan Engineering Companu Ltd	Construction & engineering	Nigeria
141	Orbit Production Ltd	Programming (TV production)	Britian
142	Financial Instrument and Investment corporation	Construction equipments	US
143	Novartis Pharma Services Inc.	Consulting & marketing for chemical products	Switzerland
144	Private joint-stock Co. Volgonefte Khimmontazh	Construction	Russia
145	Alcatel cable France	Cable equipments (supplier)	France
146	Toto S.P.A.	Construction (Road between Sofar & Mdeirej	Italy

*Source: Compiled by the author from lists provided by the Ministry of Economy and Trade in Lebanon.*

#### **5.4.1 Business interests of foreign firms (1993-98)**

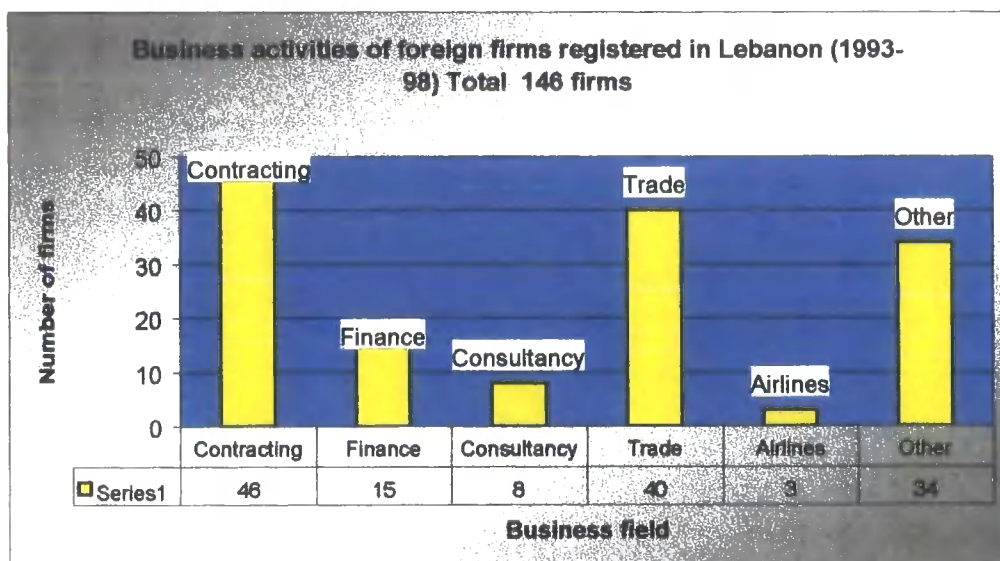
The business activities of foreign companies registered in Lebanon between 1993-98 can easily be interpreted as an indictor of the significant business opportunities in the country. It is not difficult to trace the impact of the reconstruction process. Out of the 146 companies that were registered as foreign firms, 46 firms were looking for or already executing contracting jobs. The term 'contracting' that is used in this chapter refers to companies that were involved in the rebuilding process, or were competing for infrastructure projects. It comprises firms involved in reconstruction, telecommunications, electricity, water, wastewater, transportation, and others. This was either declared in their registration files, or traced through their activities in Lebanon. However, it is very common to see a firm engaged in more than one of these activities (for example: electricity and telecom). Over 28 companies were there for construction projects; 6 for telecommunications; 7 for electricity; 3 for water; and 11 for engineering. In addition, it should be taken into consideration that consultancy companies were there mainly because of the reconstruction projects (7 companies), while a substantial number of trading companies (27) were present to provide material needed for the reconstruction process. In this research, it was decided to include under the trade category all companies involved in import-export or supplying material manufactured abroad for the new projects. Many of these companies had established a representative office that was there to promote its products in the Lebanese market. Another 14 companies were



identified as finance firms. Those were to include commercial and investment banking, insurance companies, and finance houses.

Apart from the government's plan, the rebuilding process was in action almost all over the country. This was a chance for foreign suppliers to conduct some trade business with Lebanon. Reconstruction does not necessarily mean restoring buildings and rehabilitating the infrastructure. A whole country was being 'reassembled', while almost everything required updating, to catch up with what the country missed during the years of war. Hence, the influx of foreign finance firms that found a niche in the market by offering to raise funds abroad, and help restructuring banks and finance firms that were affected by the war. All these could be considered incentives for foreign companies to operate in Lebanon during that period.

**Chart 5.3**



*Source: Compiled by the author depending on table 5.4.*

## 5.5 A survey of EU companies amongst foreign companies registered in Lebanon (93-98)

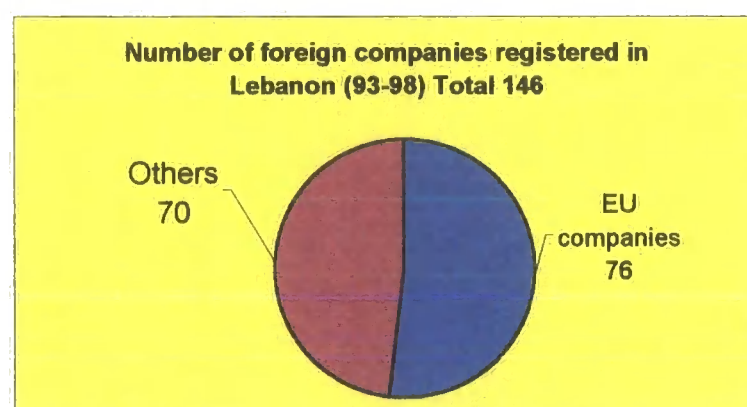
Looking at this list of foreign companies registered in Lebanon since the last quarter of 1993, the presence of EU member states companies shows clearly. Out of 146 foreign companies registered until the beginning of 1998 we find that 76 were from the European Union. That represents over 52 per cent of the whole sum of foreign companies' inflow into Lebanon. Other companies belonged to a plethora of countries, coming mainly from non-EU European and Arab countries, in addition to some US, South Asian, Canadian, Latin American and African countries.

**Table 5.5 Country of origin for foreign firms registered in Lebanon (1993-98)**

EU	Non-EU European	Arab	South Asian	US	African	Latin American	Canadian
76	20	19	8	10	2	6	3

*Source: Compiled by the author from the lists provided by the Ministry of Economy and Trade.*

**Chart 5.4**



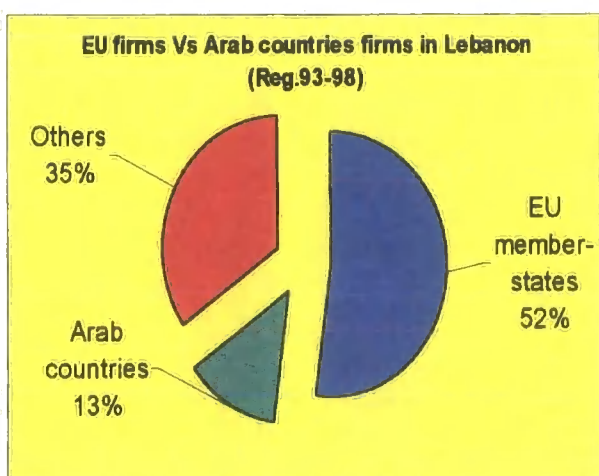
*Source: Compiled by the author from the lists provided by the Ministry of Economy and Trade.*

It is interesting to see that firms from the EU-member states registered in Lebanon have outnumbered their counterparts of other nationalities. They were over four times the number of Arab companies and five times the US ones. The limited presence of the US firms could be explained by the US ban on its citizens from travelling to Lebanon. This meant that American businessmen were not allowed to utilise the opportunities arising in Lebanon. The easing of the ban later on resulted in the arrival of some US firms. The majority of US firms were registered in 1996, the same year in which the US hosted the

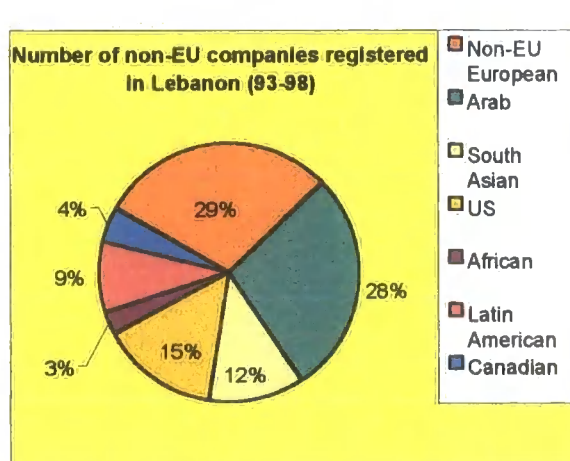
conference for 'Friends of Lebanon', to raise financial support for the Lebanese government to cover the cost of the reconstruction.

The limited presence of Arab firms (19 firms) might raise some questions, especially given the figures of inter-Arab investments mentioned earlier in this chapter. Lebanon is part of the Arab world within which remarkable capital surpluses exist. It could be argued that if the reconstruction process was creating attractive opportunities for business, then the response from the close and/or rich neighbours should be higher than that of European businesses. The factors of proximity, cultural and historical connections would support this argument. However, business response depends above all on the opportunities available and its compatibility with the firm's line of business. Arab firms that stepped in had possibly made such decision because they thought they had the ability to compete for reconstruction projects. This applies to many airlines and commercial banks. However, Arab businesses' presence in Lebanon should not be assessed through the number of Arab firms operating there within a particular period. Arab capital normally finds its way to local businesses and banks (i.e. buying shares of these businesses). Such investments cannot be ignored. Nevertheless, the activities of the majority of Arab firms are limited when compared to European, South Asian, and American firms. Looking back at the list of foreign firms in Lebanon, Arab firms' activities could be identified as construction, trade, airlines and commercial banks, in general. On the other side, EU, US, and South Asian firms had much more competitive position as their activities ranged from the supply of capital equipment for electricity and telecommunication to doing the actual job of installing power and telecom networks. Rebuilding the infrastructure of Lebanon needed technology, something that Arab firms still cannot compete in.

**Chart 5.5**



**Chart 5.6**





*Source: Compiled by the author from lists provided by the Ministry of Economy and Trade.*

### 5.5.1 Representation of EU member states among EU companies

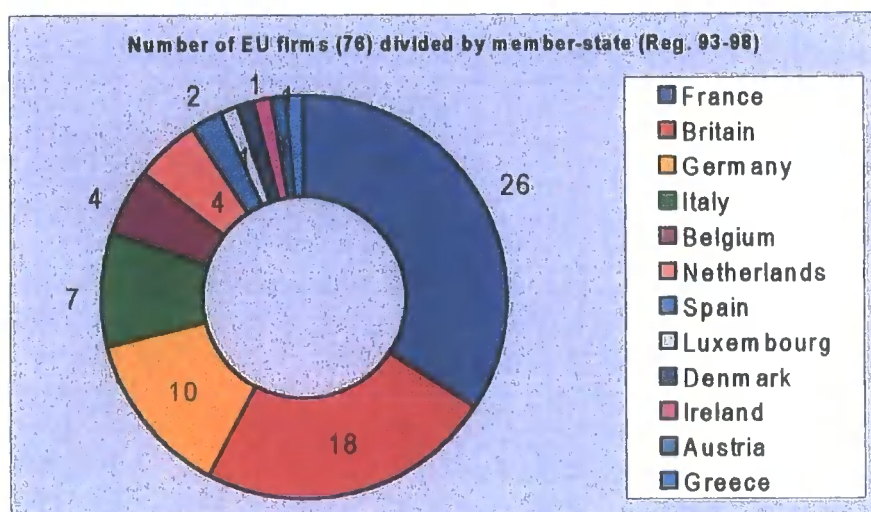
Significant differences in the number of foreign firms in Lebanon were not only between EU and non-EU firms. It was also apparent among EU firms themselves. Some EU member states were highly represented when compared to other 'colleagues' in the EU. France had the biggest representation with 26 companies out of 76. Britain and Germany followed with 18 and 10 companies, respectively. Italy had 7 companies, while others were represented with less than 5 companies each. The apparent French outnumbering of other Europeans can be related to the historical connections between France and Lebanon. The preceding review of the historical relations between Lebanon and Europe has shown how the French were not alien to the Lebanese market. Relations between the two countries can be described as being warm despite some limited intervals of tension accompanying the process of independence. Unequivocally, French companies were in the same position as their EU counterparts: private businesses are always after opportunities. No difference in this sense exists between the French, British or German firms. However, the historical connection and familiarity between the French companies and the 'Francophonic' Lebanon would have certainly been an advantage.

**Table 5.6 EU firms divided according to country of origin (Registered 93-98)**

France	Britain	Germany	Italy	Belgium	N.Lands	Spain	Luxem.	Denmark	Ireland	Austria	Greece
26	18	10	7	4	4	2	1	1	1	1	1

*Source: Compiled by the author from the lists of the Ministry of Economy and Trade.*

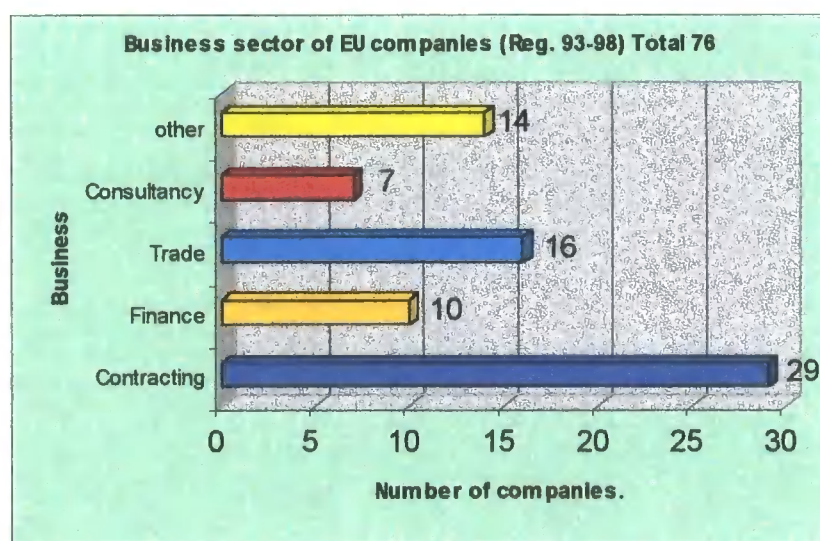
**Chart 5.7**



### 5.5.2 Business interests of EU firms

As the EU firms were the majority among foreign firms registered in Lebanon, the categorising of their activities would not differ much from the classification done earlier for business activities of foreign companies. The distribution amongst business sectors shows a great resemblance between the total foreign and total EU firms. Contracting came first followed by trade, finance, and then consultancy. 29 out of the 76 EU firms were in Lebanon for contracting purposes. Trade followed with 16 EU firms while finance activities attracted 10 firms. Firms conducting consultancy amounted to 7. In other words, 63 percent of contracting foreign firms in Lebanon came from the EU, compared to 40 per cent of foreign trading firms. Nearly two-thirds of finance firms came from the EU, while almost all consultancy firms (7 out of 8) were European. By and large, most of the earlier analysis applies here, mainly after we find that the 6 telecom foreign firms were all EU firms; 5 electricity companies out of 7 were from the EU; 5 engineering out of a total of 11; and 17 in construction out of a total 28. As it was revealed earlier, many of these contracting firms were counted more than once, as they were involved in more than one category of activities (Electricity & telecom, for instance).

**Chart 5.8**



*Source: Compiled by the author from the lists of the Ministry of Economy and Trade.*

## **5.6 EU companies partnership with local counterparts**

In addition to the EU firms that were registered in Lebanon as foreign companies, with the beginning of the reconstruction process, other EU business connections were traced among some Lebanese local companies. The European connection to these local firms was through either partnership or shareholding by European businesses in registered Lebanese firms. The Lebanese commercial law allows for foreign firms to establish local companies. This has to follow the rules stipulated in this law, particularly, the rules concerning local partnership or representation in the board of directories of each firm. Therefore, it is possible to find foreign firms registered as local Limited Liability Companies in Lebanon with no local partner at all. However, the lack of information about foreign companies in Lebanon does not allow for in-depth research, particularly concerning the size of European share in a local firm. Nevertheless, this research's aim is to highlight the presence of EU firms and identify the business sectors they are involved in to assess their business interests in Lebanon. Thus, the material available will be utilised as much as possible.

According to a study prepared by a Lebanese independent institute (Khalil Masri et Fils),<sup>448</sup> up to 100 Lebanese companies registered between 1<sup>st</sup> of January 1993 and 31<sup>st</sup> of March 1997 were subsidiaries of, or affiliated to EU companies. The data provided on these firms was not complete, leaving a remarkable amount of loopholes. However, such results were caused by the lack of information provided.

The local companies that had EU connection were registered mainly in Beirut (77 firms) and Ba'abda, the centre of Mount Lebanon (22 firms). Noticeably, none were registered in the regions of the South, North and Bekaa. This shows the centralisation of business activities in the region of the capital and the surroundings. The following list shows the distribution of these firms amongst business sectors and nationality of EU partners.

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<sup>448</sup> Lebanese companies subsidiary of, or affiliated to EU companies registered between 1-1-1993 and 31-3-1997. A survey prepared by the independent institute, Khalil Masri et Fils (Beirut:1998).

**Table 5.7 Lebanese companies subsidiary of, or affiliated to EU companies registered between 1-1-1993 and 31-3-1997**

Co	Company	Type of activity	EU partner	Country
1	Rhône-Poulenc Liban International SAL	Off-shore	part of Rhône-Poulenc Group	France
2	Etablissement Financier "BEMD" SAL	Finance. Part of Lebanese BEMO	Banque de l'Europe Méridionale.Paris (BOD)	France
3	Projects and General Supplies Co. SAL		Tradco Ltd (among the major shareholders)	Cayman Islands. Britain
4	Société de Développement des Télécommunications au Moyen-Orient "SODETEM" SAL	Telecom.	SODETEL sal. (France Cables et Radio SA is a shareholder)	France
5	Valio International Middle East SAL	Holding	Subsidiary of the Finnish Valio Dairy Product Group	Finland
6	Finnish Dairy SAL	Holding	Subsidiary of Valio Dairy Product Group	Finland
7	SALMIYA Technical Services Co. SAL	General trade and real estate		
8	Socotes Liban SARL	Inspection and survey	part of French Socotes group	France
9	Trans Services and Communications "TSC" SARL	Studies		
10	Société Foncière D'Orient-Beyrouth SAL			
11	RIWA - LAING Ltd SARL	Contracting	John Laing International Ltd is a shareholder	Britain
12	SAKO Steel Middle East SAL	Trade		
13	Betonval Lebanon SAL	Ready-mix concrete industry	Affiliated to Betonval Italian group	Italy
14	Walter BAU Liban SARL	Construction and contracting	Part of Walter Bau group	Germany
15	Royal distributors SAL	Trade	William Grant & Sons. B.V. Amsterdam	Netherlands

16	MARCEP POR Liban. Société Industrielle et Commerciale de Marbre et du Granit SAL	Trade	Marcepor-Marmoves Ceramics Portugal SA (BOD)	Portugal
17	Lebanon Invest	Holding	capital Trust SA (BOD))	Luxembourg
18	International Promoters & Advisors "IPA Lebanon" sarl	Studies and consultancy	Soficade Establishment SA (Main shareholder)	Luxembourg
19	Gras Savoye Liban sal	Insurance brokerage	part of Gras Savoye insurance group	France
20	Liban Cell sal	Telecom. (Mobile phones)	Telecom Finland	Finland
21	Hospitality Management Services SAL	Data systems	D.A.C. Systems Micros (shareholder)	France
22	Fanadec Wa Siahat SARL	Publishing of periodicals		
23	Oméga Médical SARL	Hospital equipments		France
24	Bonna SAL	Pipes industry		France
25	Addidas Middle East SAL	Trade	part of Addidas group	France
26	Hochtiff	Construction	Hochtiff (Lebanon branch)	Germany
27	Lebanese Leasing Co. SAL		Affiliated to the French Crédit Agricole group	France
28	Stanger Lebanon SARL	Laboratory testing of const. Materials		
29	Sofli SARL	Contracting, construction materials	Societe Hil sal - Lyon (shareholder)	France
30	Inchcape marketing sevice (Lebanon) SAL	Retail services	Affiliated to the large British and international Inchcape group	Britain
31	Indosuez Capital Moyen-Orient SAL	Finance		France
32	Princpe SARL	Research and studies		France
33	Quantec SAL	Marketing of IBM computer equipment	Affiliated to the European division of IBM group	Italy



34	Redland Readymix SARL	Concrete	Redland Readymix Ltd (shareholder)	Britain
35	International Distillers Vintners - Middle East SAL		Affiliated to International Distillers and Vintners (IDV)	Netherlands
36	Biaterm SARL	Petroleum suppliers for airline companies	French shareholders	France
37	Eugro Levant SARL	Monitoring activities, geotechnical	Eugro N.V.	Netherland
38	United Cargo Beirut SARL	Shipping and transit	United freight forwarders SAL	Italy
39	Ober SAL	Holding	Part of the Ober fairs & exhibition group. Ober Investment	
40	Société Franco-Libanaise "SFL" SARL	General trade		France
41	Knauf Lebanon SARL	Building materials		Greece
42	BAREP Middle East SAL	Workshop for reparation of industrial taps	Archevêque Technologie SA (Shareholder)	
43	Wartsila Diesel Middle East Ltd SAL	Electronic supplies	Warsila Diesel Int. Ltd	Finland
44	Viglienzone Adriatica (LIBANO) SARL	Off-shore		Italy
45	Services Libanais de Promotion Commerciales SAL		Alpenside Ltd	Ireland
46	Beirut Airport Services SAL		Alysia Airport Services SA	France
47	ECO MAX SAL	Operators of ECO MAX chain of retail stores	ECO MAX	France
48	Euro-Méditerranée pour le Développement SARL	Supply of technical services related to telecom	Wellcare Holding NV (main shareholder, and in BOD	Netherlands
49	Lever Fattal SAL	Manufacturing, trade & marketing of consumer goods	J-venture between Unilever and Khalil Fattal et Fils local group	
50	Davis Langdon Lebanon Ltd SARL	Engineering studies	Davis Langdon Ltd (50 % shareholder)	Britain

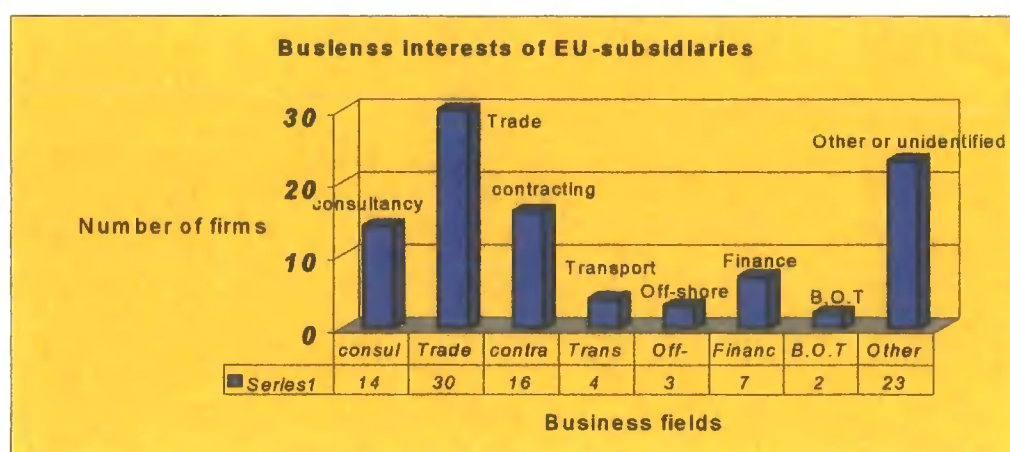
51	Gondrand SAL	Travel & transport agency	Gondrand Ltd (main shareholder)	Britain
52	Coutes Lorilleux Moyen Orient SARL	Raw material for paint		
53	Libano-Française D'Ingénierie "LFI" SARL	Engineering		France
54	Unilog Liban SAL	Data systems	Unilog SA (shareholder)	France
55	Mediterranean shipping Co. Lebanon "MSC" SARL	Trade, Cargo transport	United Agencies Ltd (main shareholder)	Ireland
56	Sucden Liban SAL	Catering services	SUCDEN Kerry SA (main shareholder)	France
57	ITALEX SARL	Chemical products for construction and	Societe Fiduciaria Vinecentine SRL (main shareholder)	Italy
58	Advanced Construction Technology Services "ACTS" SAL	Construction (execution & supervision)	RMB International Ltd BVI shareholder	
59	Tractabel Lebanon SAL	Engineering	Tractabel Development SA (main shareholder)	Belgium
60	Cos. ITAL Co. SARL	Contracting	Italcos, Cos.mar spa, Conapro SA (shareholders)	Italy
61	Middle East Capital Group (MECG) SAL	Finance	Middle East Capital Group (London)	Britain
62	Eculine Liban SARL	General transport	Affiliated to Eculine	Netherlands
63	Wilo Salmon Lebanon SARL	Electrical pumps	Pompes-Salmon SA (main shareholder)	France
64	C.C.F. Holding Liban SAL	Finance	Part of Crédit Commercial de France	France
65	GEMO Liban SARL	Enterprises, contracting & development		France
66	Partners in finance SARL	General studies & analysis	O.R.T. SA (main shareholder)	France
67	SO.I.ME Liban SAL	Ready-mix concrete industry		
68	Challenge Middle East SAL	Off-shore	Challenge International (shareholder)	

69	ICAR International SAL	Contracting	Part of ICAR contracting group	Italy
70	MKP Trading & Contracting SAL	General trade & contracting		
71	KPOS COMPUTER SYSTEM (Lebanon) SARL	Electronic equipment	KPOS computer system Ltd (shareholder)	Britain
72	Mouawad Hill SARL	Contracting	Higgs and Hill Overseas Ltd	Britain
73	Svedala Lebanon SARL	Construction equipment	Svedala Industri A-B	Sweden
74	ODA Liban SAL	Publishing of phone directory		France
75	LINDE Material Handling Middle East SARL	Public works equipment		Germany
76	Heilit Koray Lebanon SARL	Construction	Heilit Woerner Bau AG (Munchen), Koray Yapi Industri ve Ticaret	Germany, Turkey
77	Libarus SAL			
78	Sogelease Liban SAL	Leasing	Affiliated to the Société Générale banking group	France
79	Ericsson Liban SARL	Telecom.	Ericsson	Sweden
80	Paralu Bifem SARL	Aluminium contracting	French shareholder	France
81	Bureau Veritas Liban SAL		Affiliated to Bureau Veritas Technical Inspection International Group	France
82	SPR Liban SAL	Contracting	French shareholder	France
83	FTML	Telecom. Mobile phones	France Telecom.	France
84	Sol Solution Moyen - Orient	Geological studies	Sol solution SA (shareholder)	France
85	CANA Plast SAL	Plastics and derivatives	Alphacan SA	France
86	Camasut SAL	Telecom. Infrastructure studies	Camasut (main shareholder)	France

87	Comeca SARL	Cables and electrical equipment	Comeca SA (shareholder)	France
88	BATI - BOIS SARL		Financial R.J.D.C. (shareholder)	Belgium
89	Société Edrafor SAL	Geotechnical activities	Edrasis PSALLidas SA (main shareholder)	Greece
90	CEP Moyen - Orient SAL	Supervision	French shareholder	France
91	MDA Lebanon SARL	Project management	Monk Dunstone Associations Group International	Britain
92	SNAIDERO Middle East	Kitchen and office furnisher supplier	Member of INDEVCO Group SAL	
93	E.C.L. SARL	Engineering		Italy
94	France portes - New Okal SAL			France
95	Martinsart-Liban SARL	Bookshops		France
96	Medialog SAL	Data systems		France
97	Al Comust SARL	Food products and beverages		France
98	Sami Levant SARL	Transport		France
99	Géotechnique et Structure Consultants (GSC) SAL	Infrastructure studies		France

*Source: Derived by the author from lists provided by Khalil Masri et Fils Consultants, Beirut.*

**Chart 5.9**



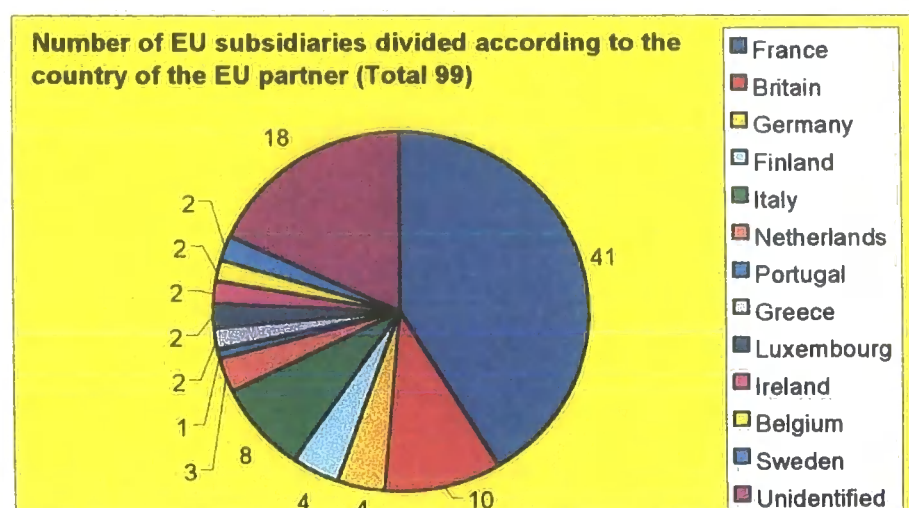
*Source: Compiled by the author from the above list (Table 5.7).*

European businesses have shown a noticeable interest in trade and contracting activities. The interests that were revealed amongst locally registered firms with EU partnership resembled the business interests of European firms registered as foreign. However, trade activities seemed to be more attractive to EU businesses than contracting. This shows some difference with the purely foreign EU firms that had a predominant interest in contracting. The term trade is used in this part to cover the same activities referred to as trade in the earlier section on foreign companies. This included export-import activities, and the supply of products manufactured abroad. This could be a local agent or representative, or a partnership. In addition, firms involved in retail are included under trade. Therefore, the significantly large share of trade activities amongst these firms could reflect a high presence of European suppliers through local firms. This remarkable presence should not be surprising given the chronic deficit in the balance of trade between Lebanon and the EU. European producers, on one side, could be attracted by the highly consuming market, while Lebanese partners (or agents), on the other side, would know the needs of the market and thus go hunting for exclusive agencies. Contracting came second with 16 firms identified as being involved in related activities. The reconstruction process would have certainly influenced the establishment of these firms. The same can be applied to the cases of finance and consultancy firms. However, the new business activity conducted by two of these locally registered firms is the B.O.T. contracting. The Build-Operate-Transfer schemes were different from other

contracting activities because they involved investment by the firm that would expect to recoup its investment profitably before handing the new business to the government.

The representation of EU member states amongst these firms reflected a prominent presence of French business interests. Of the 99 subsidiaries, 41 firms were identified as having a French connection. Britain came second again but only with 10 firms. This can only reflect the strong economic relations between Lebanon and France. Out of the 15 countries of the EU, 12 countries were represented. However, the French had the upper hand with over 40 per cent. This French predominance will show again in the following parts of this chapter while discussing the share of EU firms in the business opportunities raised by the reconstruction process.

**Chart 5.10**



*Source: Compiled by the author from the list provided earlier in Table 5.7.*

## 5.7 EU firms share in public sector contracts

We have established earlier that the commencement of the reconstruction process instigated the flow of European firms into Lebanon after 1993. The rebuilding of the country's infrastructure was the major catalyst for this influx. The data used earlier in this chapter shows clearly how almost all of them arrived after the beginning of the

rebuilding process, and with the majority being interested in business related to the reconstruction process. Hereafter we shall find out the role these firms played in the rebuilding process, and in fact, how successful they were in gaining contracts from the government. The data provided in this section would indicate the size of these firms' activities, and compensate for the lack of data on the capitalisation of foreign firms operating in Lebanon. The activities of the EU firms within the contracting process will be assessed and compared to non-EU firms. The two factors used in this process are, firstly, the number of EU firms rewarded major contracts in the various aspects of the reconstruction process, as opposed to non-EU firms. Secondly, the value of contracts taken by EU firms against those of non-EU firms.

A major problem in collecting material for this part of the research was tracing the firms that were awarded contracts in the rebuilding of Lebanon's infrastructure. There are no publications by the government that give details about the firms awarded contracts. The CDR in its early reports used to name the contracting firms but stopped providing this information from 1995 onwards, confining their reports to details of contracts without mentioning contractors. However, some major contracts received a little more details in the reports by which the name of the contracting company was given. The alternative was to follow news reports through economic periodicals, which were covering the contracting procedures.

#### **5.7.1 EU companies in the rehabilitation of Lebanon's electricity**

The power sector was a major part of the reconstruction plan due to the important role of electricity in any development process. Lebanon's electricity network was utterly devastated during the war: Consequently, production capacity was far below the demand causing hideous rationing. The poor network needed complete replacement. The rehabilitation of this sector was given priority by the Lebanon's government, which was keen to attract foreign businesses into Lebanon. Electricity is one of the basic needs which foreign businesses, and local as well, would consider essential while considering establishing operation in a country.

The massive plan opened the door for EU electricity companies to flow into Lebanon. The size of the projects imposed the need for experienced companies that could provide

capital equipment and install it. Thus, the share of EU firms in contracted projects in Lebanon showed mostly in the electricity sector. The total funds allocated for the electricity sector reached US\$ 1,337.9 m by the end of 1998. Out of this total, the share of EU firms reached around US\$ 1,136.22 m (Around 85 per cent of the total job was taken by EU companies). Looking at the types of projects, they ranged between consultancy, power plants rehabilitation, or building new plants and networking. Almost 23 contracts out of a total of 56 went to EU firms. Obviously, they were the pricey ones.

Among the EU countries, French companies had the highest share in both the number and value of contracts: around 17 contracts with a value of US\$ 420.07 m. Italian companies followed the French closely in terms of value (US\$ 413,5 m) with only three contracts. German firms received around US\$ 291.15 m with three contracts as well.

**Table 5.8 Contracts taken by EU firms in the rebuilding of the electricity sector**

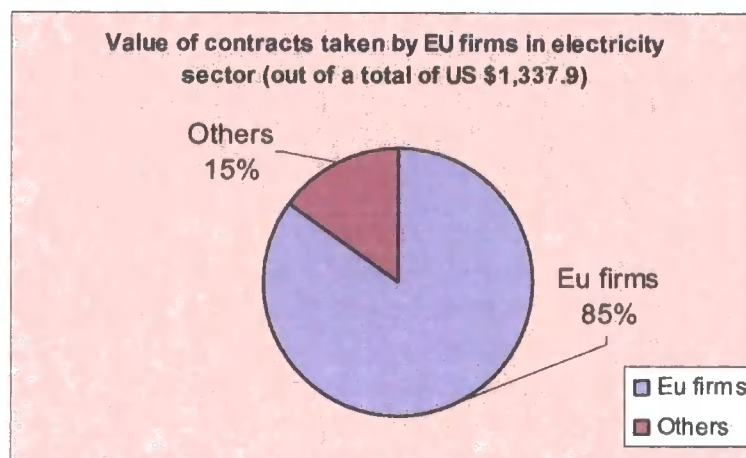
ID	Company	Contract	Value US\$M	Country	Funding	Starting Date	Duration
1	M ELEC	Rehabilitation of two substations (Jamhour & Bsalim)	7	France	France	01/05/93	12 months
2	Electricite de France	Supervision for work on the rehab. Prog.	12.2	France	France	01/07/93	21 months, renewed for 20 months
3	Electricite de France	EDL reorganisation study	6.39	France	France	01/07/93	21 months, renewed for 18 months
4	Ansaldo	Power plant rehabilitation	106	Italy	Leb, Kuwait, AFESD, KFAED	01/10/93	18 months
5	Clemessy	Rehabilitation of distribution (Greater Beirut)	51	France	Leb, Wk, EIB	01/11/93	18 months
6	Bouygues	Rehabilitation of distribution (regions)	52	France	Leb, WB, EIB	01/11/93	18 months
7	Electricity Supply Board of Ireland	Sector implementation unit	5.2	Ireland	EU	01/12/93	2 years, extended for 6 months



8	Ansaldo	Building Zahrani combined cycle power plant	260	Italy	Exp & commercial credits, AFESD	01/01/95	30 months
9	Siemens	Build Beddawi power plant	274	Germany	Exp & commercial credits, AFESD	01/01/95	30 months
10	European Gas Turbines	Installation of new gas turbines at Tyre	32	France		01/05/95	12 months
11	GEC Alsthom	Installation of new gas turbines in Baalbeck	29	France		01/05/95	12 months
12	Clemessy	Additional rehabilitation of distribution	10	France	IBRD	01/09/95	10 months
13	Electricite de France	Supervision of supply and installation of gas turbines in Baalbeck and Tyre	0.89	France	France	01/09/95	12 months
14	Electricite de France	Training EDL personnel	0.69	France		01/09/95	
15	Electricite de France	Supervision building of Zahrani & Bedawi plants	11	France	France	01/09/95	30 months
16	Electricite de France	Management system for MV subscribers including value of equipment	8.7	France		01/09/95	
17	Fichtner	Environmental impact assessment	0.15	Germany	IBRD	01/11/95	4 months
18	Electricite de France	Consultancy (collection improvement plan)	27.5	France	France	01/12/95	15 months, renewed
19	Groupe Schneider	Building four metal-clad substations in Beirut	99	France		01/09/96	
20	Spie Enertrans / Clemessy / AEG	Installation of three 220KV substations in the regions	34	France / Germany		01/09/96	
21	Electricite de France	Supervision for substations projects	5	France		01/09/96	
22	Pirelli General	Installation of underground cables (Beddawi-Behsas)	47.5	Italy	EIB, IBRD,	01/07/97	
23	Alcatel Cables	Installation of underground cables in Greater Beirut	57	France	EIB, IBRD	01/12/97	

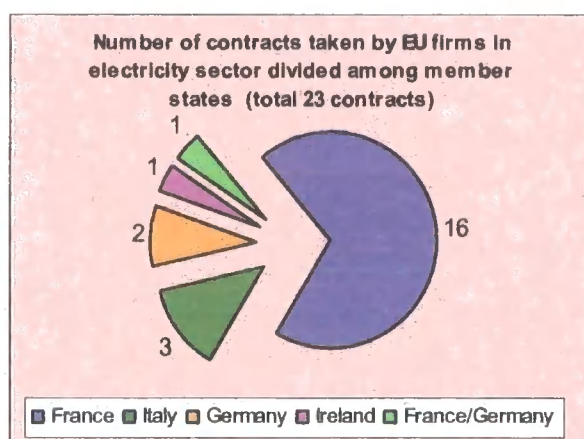
Source: Compiled by the author from lists provided by the Council for Development and Reconstruction (CDR) *Progress Report*.

Chart 5.11



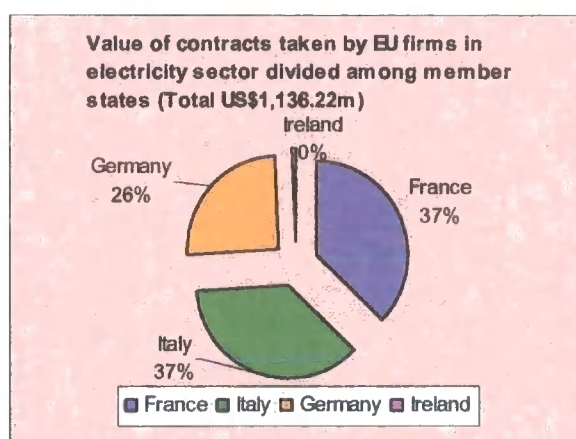
Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

Chart 5.12



Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

Chart 5.13



Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

### 5.7.2 EU companies in the rebuilding of the telecommunication sector

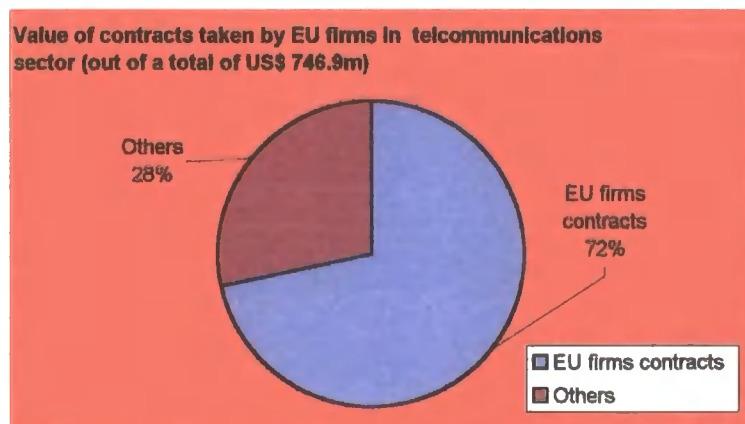
This is another sector that showed an abundant presence of EU firms. If electricity was devastated in Lebanon in the post-war period, telecommunications were virtually non-existent. In telephones, an overall rehabilitation was needed for the existing old networks, in addition to extending networks to areas that had never previously had telephone services. Here again, EU firms had the opportunity to seize as many contracts

as possible. Contracts comprised consultancy, extending networks and supplying equipment. Out of a total of US\$ 746.7 m allocated for telecommunication projects, firms from the EU caught US\$ 534.3 m (72 per cent).

**Table 5.9 Contracts awarded by EU firms in Telecommunication sector**

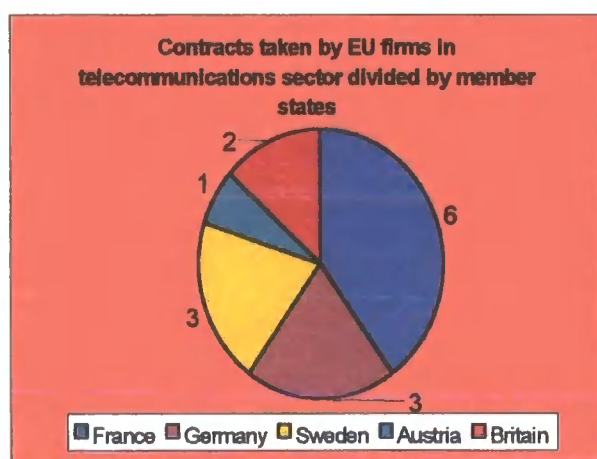
ID	Company	Contract	Value US\$ m	Country	Funding	Starting date	Duration
1	Deloitte & Touche	Sector organisation study	3.102	Britain	WB	01/02/93	12 months, renewed for 4 months (July 95)
2	Alcatel	Supply of spare parts & equipment to Ministry of Telecom	1.8	France	France	01/09/93	12 months
3	Alcatel	Rehab & extend of exchange equipment	21.68	France	Leb	01/10/93	18 months
4	Siemens	Rehab & extend of exchange equipment	33.68	Germany	Leb	01/10/93	24 months
5	Ericsson	Rehab & extend of exchange equipment	22.72	Sweden	Leb	01/10/93	18 months
6	Alcatel	International network extension: earth station	7.87	France	Leb	01/05/94	18 months
7	Cable & Wireless	Telecom management	5.662	Britain	IBRD	01/09/94	36 months
8	Alcatel	Rehab. & installation of new fixed phone lines	130.7	France	Leb	01/09/94	36 months
9	Siemens	Rehab. & installation of new fixed phone lines	153	Germany	Leb	01/09/94	36 months
10	Ericsson	Rehab. & installation of new fixed phone lines	147	Sweden	Leb	01/09/94	36 months
11	Progis	Inventory and stock management software for MPT	0.152	Austria	Leb	01/07/95	3 months
12	Sofrecom	Local network studies at 40 sites	1.83	France	France	01/02/96	12 months
13	Ericsson	Equipment for inter-change traffic	1.96	Sweden	Leb	01/02/96	4 months
14	Siemens	Equipment for inter-change traffic	1.32	Germany	Leb	01/02/96	4 months
15	Alcatel	Equipment for inter-change traffic	1.83	France	Leb	01/02/96	4 months

**Chart 5.14**

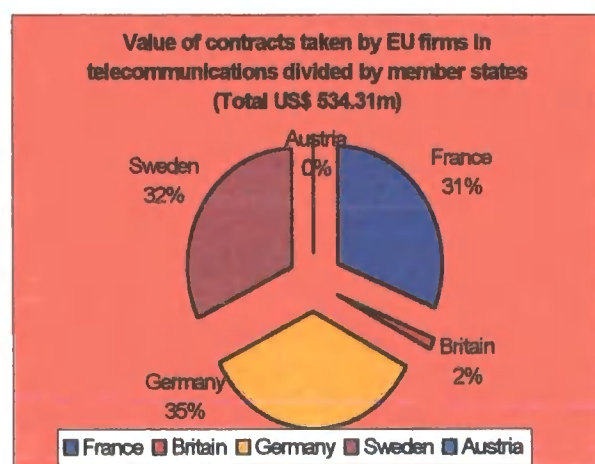


*Source: Compiled by the author. Figures derived from CDR Progress Reports.*

**Chart 5.15**



**Chart 5.16**



*Source: Compiled by the author. Figures derived from CDR Progress Reports.*

### **5.7.3 Transportation (including airports and ports)**

The share of contracts awarded to EU firms in the transportation sector was not little. In terms of value, they snatched up to 44 per cent of the total expenditure of the government on that sector. However, the number of opportunities was limited in this sector. Certainly, the transportation networks (roads mainly) were devastated and needed a massive plan for upgrading. However, those jobs were taken by local and Arab firms. Only giant projects were seized by EU firms. Beirut International Airport is the major

project in this sector. At a cost of US\$ 387 m, it was taken by a joint venture between the German Hochtief and Arab (Athens based) CCC. The expansion of the port of Beirut is another project that was given to the Spanish joint venture Entrecanales – Cubiertas. This explains how contracts involving EU firms mounted up to 44 per cent of the total value. The Spanish firms' contract was over a US\$ 100 m while the German Hochtief joint venture with CCC was just below US\$ 400 m.

Again, French firms received the highest number of contracts (10 contracts). However, the biggest share in value went to German firms represented by Hochtief (74 per cent through one contract). We should take into consideration that the German company didn't get all the amount because it was through a joint venture. Nevertheless, even with half of the contract value, the German company comes first with around US\$ 200 m (around 38 per cent).

**Table 5.10 Contracts awarded to EU firms in transportation sector**

ID	Company	Contract	Value US\$m	Country	Funding	Starting date	Duration
1	Sofrerail	Railways study	0.8	France	Leb, France	01/09/93	9 months
2	Port Autonome de Marseille	Consultancy (port)	1.5	France	Leb, EIB	01/12/93	36 months
3	Team / IAURIF / SOFRETU	Consultancy (Traffic studies)	2.4	Local/ France	Leb, France	01/01/94	18 months
4	Dan Group	Sector implementation unit	2.7	Denmark	EU	01/05/94	36 months
5	Samtsc - Gisman	Restoration of the light-house at Ras-Beirut	0.06	France	France	01/09/94	
6	Hochtief/CCC (joint venture)	Airport	387	Germany/ Local	Leb, EIB, KFAED	01/09/94	48 months
7	Aéroport de Paris	Organisational study of the Directorate General of Civil Aviation, and supply of computer software	2.49	France	France	01/08/96	24 months
8	Aéroport de Paris	Training in air traffic control procedures	2.7	France	France	01/08/96	15 months
9	Aéroport de Paris	Meteorological equipment	3.1	France	France	01/08/96	16 months
10	Aéroport de Paris	Radar simulator	2.6	France	France	01/08/96	19 months



11	Aéroport de Paris	Training equipment for radar maintenance staff	1	France	France	01/08/96	10 months
12	Aéroport de Paris	Training equipment for aircraft maintenance staff	2.4	France	France	01/08/96	14 months
13	Entrecanales / Cubiertas	Rehab & extension of the port of Beirut	102.8	Spain	EIB, Leb	15/01/97	24 months
14	SAR / Mowlem	Clearance of wrecks from all basins in the port of Beirut	4.5	Britain	Leb	01/09/97	

Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

Chart 5.17

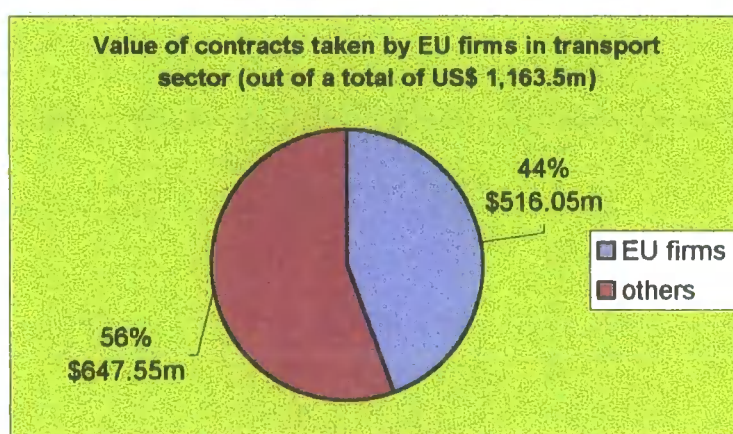


Chart 5.18

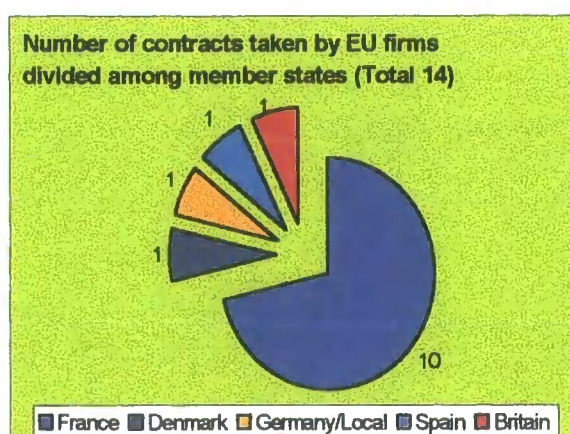
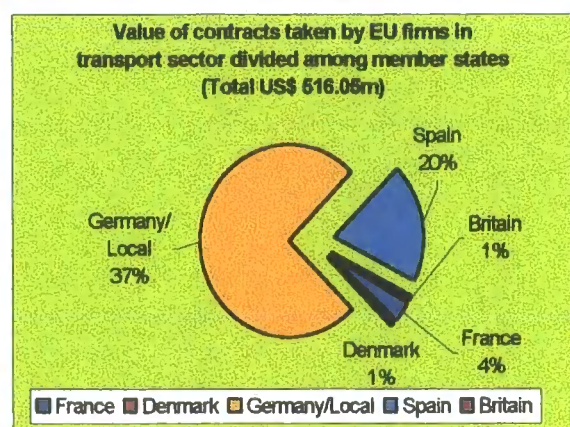


Chart 5.19



Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

## 5.7.4 Water supply and wastewater

This sector included the rehabilitation of water supply networks, in addition to pumping and treatment plants. It also contained the wastewater projects that dealt with networking and treatment plants. The EU firms' share in this sector was not as high as in other sectors. It reached US\$ 75.3 m (16 per cent) out of the total value of contracts in this sector (US\$ 477.2 m). The 11 contracts that the various EU firms gained in this sector varied between consultancy, preparation of studies and equipment supply. The remainder of the contracts were taken by local companies. British firms gained four contracts with a value of around US\$ 21 m. French firms received three contracts valued at around US\$ 41 m (55 per cent of EU firms share). Italian and Greek firms got two contracts each. The value of their contracts were around US\$ 11.55 m and US\$ 1.43 m, respectively.

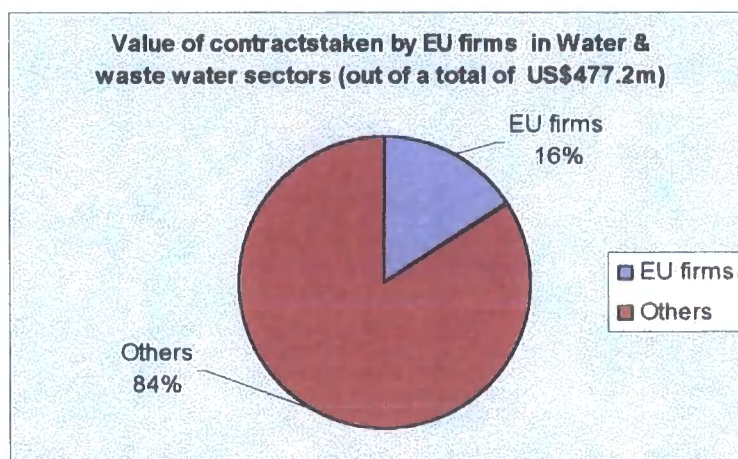
**Table 5.11 Contracts awarded to EU firms in water supply and wastewater sector**

Co No	Company	Contract	Value US\$m	Country	Funding	Starting date	Duration
1	EMIT and SELC (consortium)	Extension of Dbaye water treatment plant	5.73	Italy	Italy	01/12/92	30 months
2	Lyonnaise des Eaux & Dumez (consortium)	Management consultancy	2.6	France	France	01/08/93	36 months
3	Montgomery Watson-Engico	Updating studies on Awali-Beirut water conveyor	1.7	Britain	SFD	01/12/93	18 months
4	Binnie & Partners	Sector implementation unit	6.1	Britain	EU	01/02/94	36 months
5	Gico Costruzioni	NERP 1st year prog.wastewater main server repairs & extension	5.82	Italy	IBRD/EIB/Leb	01/04/94	12 months
6	E.N.B	NERP 1st year prog. Supervision: wastewater, North Lebanon	0.29	Greece	IBRD / EIB	01/04/94	12 months
7	E.N.B	NERP 1st year prog.supervision: water supply, North Lebanon	1.14	Greece	IBRD/EIB	01/04/94	12 months

8	Howard Humphreys	Consultancy for water supply & wastewater in the regions	9.83	Britain	IBRD	01/10/94	30 months
9	Sir Alexander Gibb / Khatib & Alami / KCIC	Consultancy for water supply & wastewater in Greater Beirut	3.39	Britain/ Local	KFAED	01/11/94	26 months
10	Pont à Mousson	Supply of pipes to Barouk water board	4.7	France		01/06/95	
11	OTV	Rehab & extension of water treatment plants	34	France	France (French protocols)	01/08/96	36 months

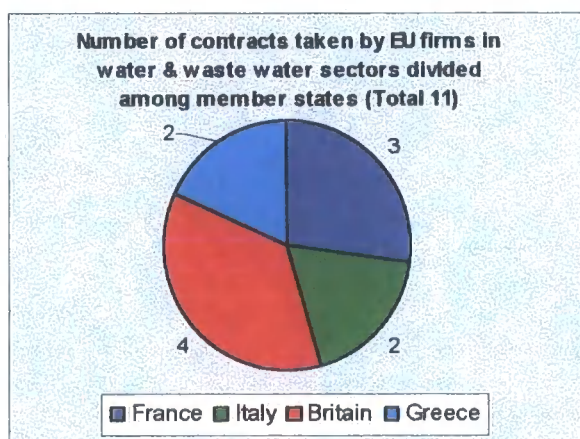
Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

**Chart 5.20**

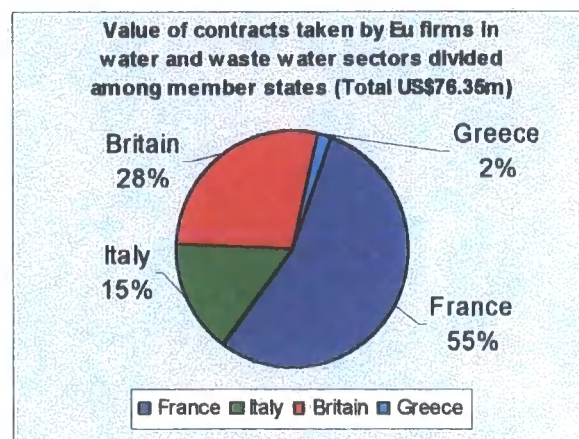


Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

**Chart 5.21**



**Chart 5.22**



Source: Compiled by the author. Figures derived from CDR *Progress Reports*.



### 5.7.5 Solid waste treatment

The portion for EU firms in this sector was humble compared to other sectors; a total of five contracts only valued at around US\$ 8.91 m. When compared to the total expenditure by the government on this sector, US\$ 665.3 m, the EU firms' share does not exceed 1 per cent. Most of the expenditure has been allocated for projects to provide landfills, and garbage collection contracts. These contracts were taken by local firms. EU firms, as the table shows, mainly got contracts for consultancy.

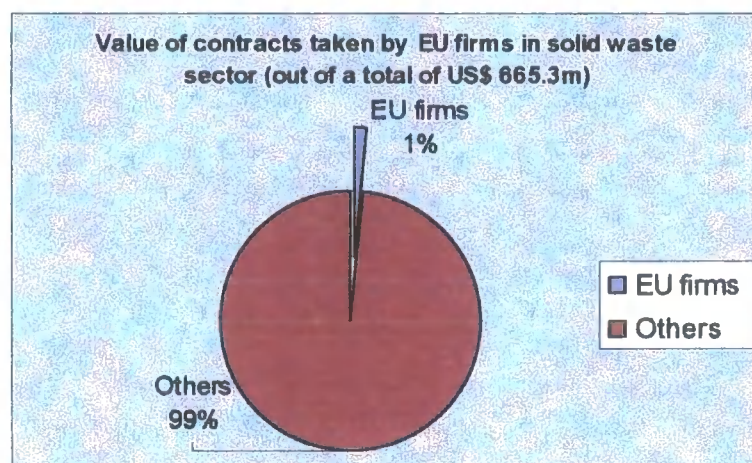
French companies again got the highest share of contracts (4 contracts) valued at US\$ 7.21 m. A single contract was taken by a German-Belgium joint venture for a total value of US\$ 1.7 m only.

**Table 5.12 Contracts awarded to EU firms in solid waste treatment**

	Company	Contract	Value (US\$m)	Country	Funding	Starting date	Duration
1	CREED	Consultancy services for landfill sites	1.53	France	WB	07/01/94	12 months
2	CREED	Supervision for the Rehab of Qarantina plant	0.19	France	WB	07/01/94	12 months
3	OTV	Rehab of treatment plant (Qarantina) civil & mechanical works	5.3	France	WB	27/01/94	8 months
4	Transtec/ Fichtner	Sector implementation unit (consultancy)	1.7	Belgium/ German	EU	30/04/94	36 months
5	CREED / Liban Consult	Long term strategy for the solid waste sector	0.19	France/ Local	IBRD	01/12/94	

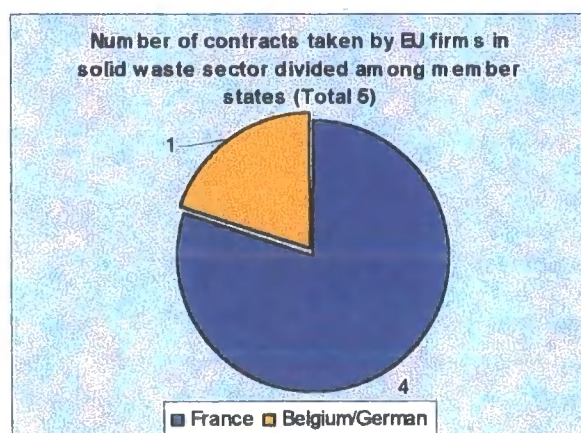
*Source: Compiled by the author. Figures derived from CDR Progress Reports.*

**Chart 5.23**

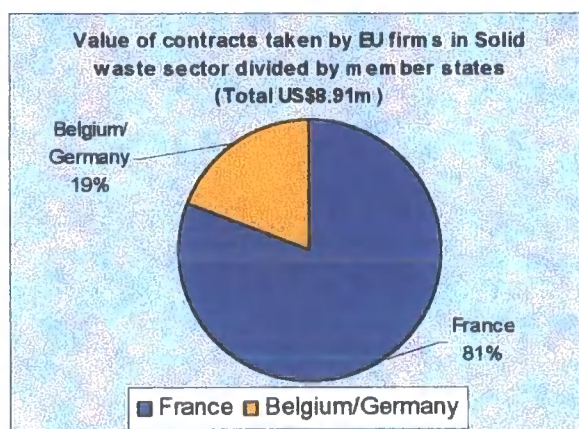


Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

**Chart 5.24**



**Chart 5.25**



Source: Compiled by the author. Figures derived from CDR *Progress Reports*.

### 5.7.6 National education, higher education, and sports

The rebuilding of this sector offered few opportunities for EU firms in terms of numbers of contracts, despite the huge number of projects. The fact that this sector involved all state schools and the national university buildings, in addition to sports complexes, created a huge number of opportunities. However, most of these contracts were very small in value due to their sizes (reconstructing schools and erecting new ones). Local companies got most of these contracts. Having said that, we should not get the impression that EU firms were crowded out in this sector. On the contrary, contracts that involved EU firms were valued at around US\$ 274.22 m. This figure surprisingly represented 61 per cent of the government's total expenditure allocated for this sector. I

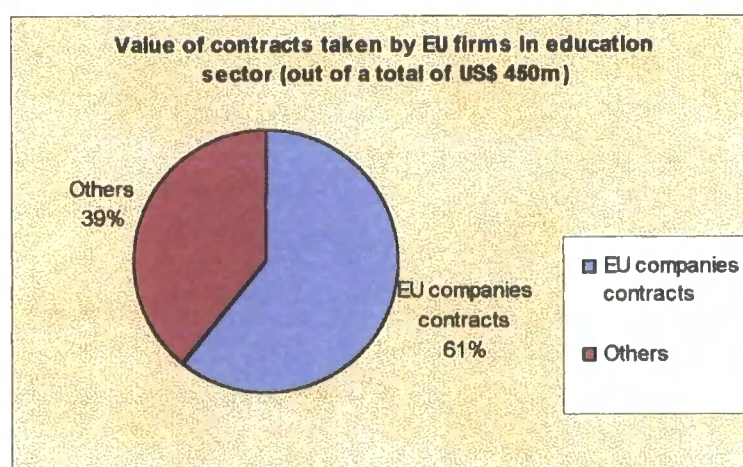
managed to trace five contracts. Three of them were taken by Italian firms but were relatively small (just over US\$ 1 m together) All were supply contracts. The British Trafalgar House (later Kvaerner) got a very 'prestigious' contract to rebuild the main sports complex in the country at a cost around US\$ 74 m. The German Zublin gained the contract for the building of the new campus for the Lebanese University. The value of the contract was around US\$ 199 m. However, Zublin is not alone in that contract. Some local firms and a Turkish one have got a share of the contract but the percentage has not been disclosed.

**Table 5.13 Contract awarded to EU firms in education and sports sectors**

No	Company	Contract	Value US\$m	Country	Funding	Starting date	Duration
1	Alessandrini Strumentazione	Equipment for secondary schools	0.25	Italy	Italy	01/09/94	4 months
2	Bicasa SPA	Equipment for secondary schools	0.19	Italy	Italy	01/09/94	4 months
3	Tema International	Equipment for secondary schools	0.78	Italy	Italy	01/09/94	4 months
4	Trafalgar House (later Kvaerner)	Building sports complex	74	Britain	Saudi Arabia, Kuwait, Leb	01/09/94	23 months
5	Zublin	Building Lebanese University campus (Hadath)	199	Germany	Saudi Arabia, Oman, IBD, Leb	01/08/97	36 months

*Source: Compiled by the author. Figures derived from CDR Progress Reports.*

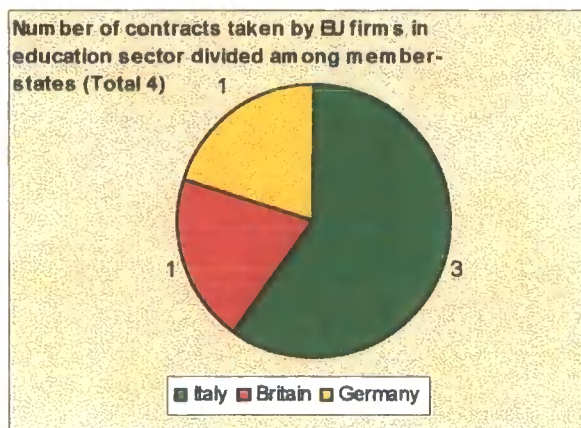
**Chart 5.26**



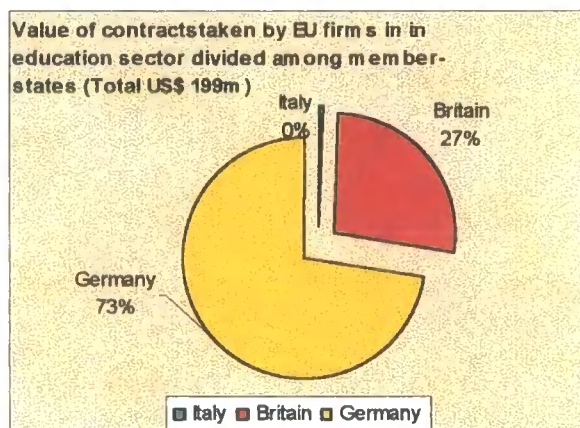
*Source: Compiled by the author. Figures derived from CDR Progress Reports.*



**Chart 5.27**



**Chart 5.28**



*Source: Compiled by the author. Figures derived from CDR Progress Reports.*

## 5.8 Conclusion

The survey has proved that EU businesses represented the predominant foreign activity in the Lebanese economy during the reconstruction period. It also provided a framework for assessing the main business interests of the EU firms. The sectors of contracting, trade, and finance proved to be the most favoured amongst businesses. However, contracting stands out as the major reason behind the influx of EU firms and many other foreign firms. Obviously, the commencement of the reconstruction process instigated the flow of such foreign companies into Lebanon. The promising opportunities arising from the need to rebuild the devastated infrastructure attracted a number of foreign firms that had had no previous relations with Lebanon. Therefore, the influx of foreign companies – including EU ones – was not merely a return of foreign firms that had fled the country during the civil war. On the contrary, the majority of these firms were being registered for the first time. Multinational firms involved in power generation, construction, or telecommunication were particularly motivated by the opportunities arising from the need to rebuild these sectors. The data on the EU firms' share in the infrastructure rehabilitation showed how successful these EU firms were in snatching high value contracts. However, it could be argued that many of the EU firms have benefited from the conditional aid provided by the EU and the member states. The previous chapters had shown that some of the aid originating from the EU or the member states was conditional (Chapter Two, the section on EU funding of reconstruction). The data provided on the source of funding for every contract supports

this argument. It is not surprising then if projects sponsored by French financial protocols were contracted to Electricité de France or Aéroport de Paris. Nonetheless, this does not deny the fact that the calibre of these firms was needed for the majority of the rehabilitation projects. They obviously offered a high quality product that other local and Arab firms could not provide. It was impossible for projects in electricity and telecommunication, for instance, to be taken by local firms who did not have the necessary qualifications.

The survey has clearly shown the impressive presence of French firms compared to other European counterparts. The special historical relations between Lebanon and France have inevitably contributed to the prominent presence of French firms. The French have developed strong links with the population of Lebanon. The Francophonic aspect of Lebanon, in which a substantial part of the population speaks the French language, made it easier to forge links between the two countries. The French also had a past experience in the infrastructure building of Lebanon at the turn of the 20<sup>th</sup> century. They were also involved in operating the country's utilities sector until its independence in 1943. These factors must have given the French a comparative advantage against their counterparts in seeking business opportunities in Lebanon. In contracting, the factor of conditional aid provided by France should not be ignored. The conditional French funding for a plethora of projects helped many French firms in seizing these projects. In the case of funding coming from the EU, the French, and other EU firms, had an advantage compared to other foreign firms bidding for the same projects.<sup>449</sup>

It has to be said, however, that the survey of EU firms in Lebanon did not help in identifying firms that are conducting direct investment from others engaged in different sort of business activities. The lists of registration did not clarify whether these firms are investing or not. It is indeed difficult to judge whether a firm is conducting investment or not, without investigating its activities in the country. Thus, in the next chapter, a number of EU firms' case studies will be investigated and compared. By the end of the chapter, a profile of EU private direct investments in Lebanon is hoped to be established.

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<sup>449</sup> If a project is funded by the EU, only EU and local firms can take it. In case of French funding, only French and local firms can be awarded the project. (Interview with Al-Fadl Shalak, Ex-Chairman of the Council for Development and Reconstruction. Beirut. September 2000).

## **Chapter Six: Case-Study Firms on EU Private Direct Investments in Lebanon**

### **6.1 Introduction**

The findings of Chapter Five have ascertained the extent of EU private business activities in Lebanon. It determined that only a small proportion of those activities appeared to fall directly into the category of FDI. Most were engaged in contracting or trade. This chapter aims to examine more closely the nature of EU private business activity in Lebanon through the close study of case studies. It will determine to what extent the firms studied were engaged in FDI, and the reasons why firms have or have not engaged in FDI. The criteria outlined in Chapter Four will be used as theoretical tools for identifying incentives and disincentives.

We have already ascertained that amongst the EU firms registered in Lebanon as foreign firms, the three business activities that proved to be very popular were contracting, trade and finance. Companies involved in contracting activities (mainly construction) numbered 29 firms; trade attracted about 16 firms; and finance about 10. These figures include the EU firms registered between 1993–1998 only. Inevitably, these figures would increase if we were to add the number of EU businesses registered as local firms through partnership or any other kind of affiliation. Those included 16 firms involved in contracting (in addition to two B.O.T. contracting firms), and around 30 trading firms. Moreover, the EU firms that were already operating in Lebanon before 1993 should not be ignored. As discussed earlier in the previous chapter, the concentration of EU businesses in those sectors is not surprising when the massive national reconstruction plan is taken in consideration.

As these three lines of business activities are dominant, the case studies for this research were chosen from firms involved in these activities. The way the case studies will be discussed is as follows: I will identify a few firms in every sector with similar activities; I will study the case of one of these firms in details, and then use the other brief cases to provide supporting material. The overall aim of this chapter is to assess the interest of each firm in Lebanon, the reasons for choosing their particular activities, and to determine the type of business EU firms are involved in whilst in Lebanon, by figuring out whose business could be considered FDI, and whose could not. The information

collected during the fieldwork in Lebanon through interviews with representatives of the EU firms discussed later in this chapter will pave the way for a comprehensive discussion of motives and obstacles for investment in Lebanon.

## **6.2 Trade (retail)**

The trade sector involves numerous lines of activities, which range from import-export to marketing and retail. I have chosen to focus on one line of trade business, which is retailing. The reason behind this selection is partly due to the apparent presence of the new 'giant' retailing supermarkets. It is one of the sectors that some foreign firms are represented in, either directly or through a local representative. There were some local retail supermarkets in Lebanon. Those were alone in the market before the arrival of EU brands. The firms covered in this study are: Inchcape (Spinneys), Ecomax, and ADMIC (BHV, MonoPrix).

### **6.2.1 Inchcape Retail Services –Lebanon SAL (Spinneys)**

Lebanon's Inchcape Retail Services was wholly owned by Spinneys at the time of its arrival in Lebanon. Spinneys was a holding company, which was in turn held by another holding company, the UK-based Inchcape plc. The mother company was operating at two levels: Spinneys was a holding company that owns various percentage shares; in the case of Lebanon its holding was of 100 per cent, while in its Gulf operations they were of 49 per cent. Spinneys was in turn owned by Inchcape plc.

Spinneys was established in 1948. However, it has changed hands six times in the last ten years: It was part of a family-owned company, Steel Brothers, but was sold to the British and Commonwealth Company. The latter was de-merged into two halves; the first went bankrupt while the second was subject to a management buy out. It was sold to an investment company, which was part of the Novel Group. This group went bankrupt and was subsequently bought by Inchcape plc in 1992.

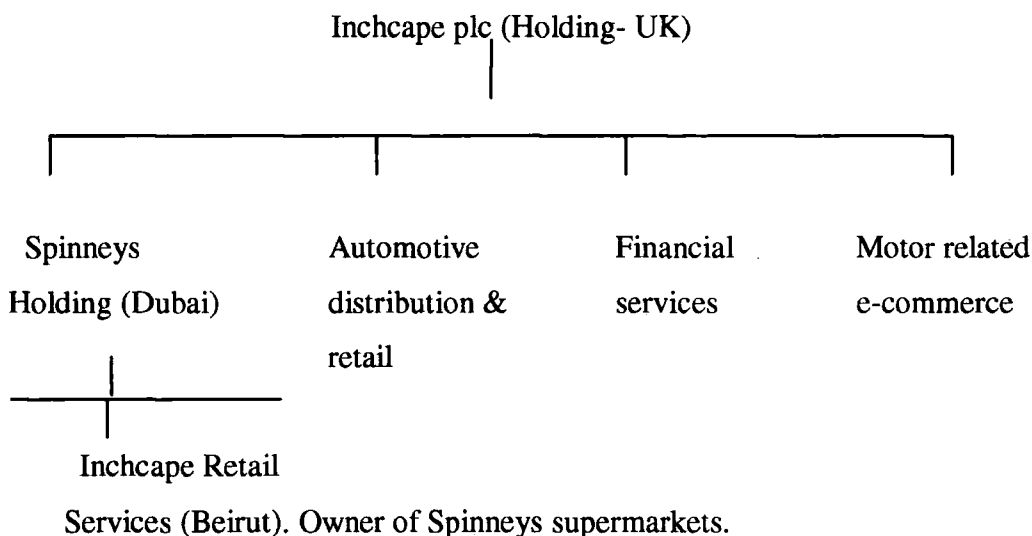
In Lebanon, Spinneys is just a brand name not a company, according to the general manager of Inchcape Retail Services- Lebanon SAL, Michael Wright.

*"We have other companies around the Gulf that have Spinneys incorporated with the company's name, like Spinneys Dubai, Spinneys Abu Dhabi. In this context, the*

*company is Inchcape Retail Services – Lebanon, and we have Spinneys as a trade mark.*”<sup>450</sup>

Inchcape plc has a wide range of activities in the UK. It used to be on the FTSE 100 but dropped out recently because of the collapse of its share price after a sharp hike in the value of the Yen. The reason was that Inchcape plc had Toyota concessions across Europe.

In the Gulf region, Spinneys has often had multi-role, or multi-stream companies. Spinneys Dubai has a consumer division, retail, catering, ship handling, export services, and others. In Lebanon, the company’s activities are confined to supermarkets only.



Spinneys have operated in Lebanon since 1948, the time the company was formed. Its operations comprised supermarkets and consumer products distribution until the beginning of the civil war when the supermarkets were closed “due to their dangerous locality”. The company carried on in the distribution business throughout the war though. With the end of the war, the company sold its share in that business, took the name back, and “decided that the future is in retail”. A feasibility study was conducted in 1994-95, and by 1996, Mr Wright moved to Beirut to start the process of doing the deal on the site and setting up operations.

When the fieldwork for this research was conducted, the company was preparing to open its first supermarket in the eastern suburb of Beirut, Dbayieh, in six weeks time.

<sup>450</sup> Author’s interview with General Manager at Inchcape Retail Services – Lebanon, Michael Wright.



The company had an initial go ahead for seven branches from the parent company in London. The potential for more would be assessed in the course of time. Beirut and the suburbs would come first, and the provincial cities later. Obviously, the parent-firm was testing the market through its pilot project. Despite the historical connection that Spinneys had with Lebanon, Inchcape's operations in Lebanon still faced the same risks that face any business operation in a foreign market.

The overall investment in Spinneys supermarkets was over US\$ 11 m. However, this amount was not paid in full by the parent-firm only. The company leased the premises from a Lebanese owner whose investment in the building is part of that total investment figure. The capital paid by Inchcape was around US\$ 6 m.<sup>451</sup> In fact, it could be argued that the Spinneys project has instigated local investment in real estate to provide property for Spinneys supermarkets. On the other hand, the foreign firm is minimising the risk as much as possible by leasing property instead of buying it.

#### **6.2.1.1 Incentives for Inchcape's investment in Lebanon**

Inchcape holds the view that retailing is an area that they want to move into more strongly. Operations in retailing already existed in Dubai, Abu Dhabi, Muscat, and Bahrain. The company believes that the retailing business in the Middle East has got a future as "markets mature" in this region. "They look for countries to return to or to expand into, and Lebanon was one of the first countries to return to" The reasons are, according to Mr. Wright:

- The people, their expectations, and their more Western life style. The historical relations between Lebanon and Europe and the missionaries that settled in it exposed its population to huge Western influence. In addition, the large number of Lebanese emigrants in Europe, US and Latin America keeps the population updated with all Western innovations. Add to that the temporary residencies in Europe of Lebanese who fled their country during the war. All these factors support Spinneys' assumption that their projected Western style supermarket would be welcomed.

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Beirut July 1998.

<sup>451</sup> Ibid.

- The higher GDP per capita compared to neighbouring countries like Syria and Jordan. Lebanon's GDP per head reached US\$ 4,219.6 in 1996 while in Syria it was US\$ 1,070, and US\$ 1,634 in Jordan. In Egypt it was US\$ 1,228<sup>452</sup>.

**Table 6.1 GDP per capita in Lebanon and the neighbouring countries**

Country / 1996	Lebanon	Syria	Jordan	Egypt
GDP per head US\$	4,219.6(a)	1,070	1,634	1,288

(a): estimated according to the exchange rate of the Lebanese pound against US dollar in 1996.

Source: EIU Country Profile: Syria; Jordan; Lebanon.

- The consumer purchase ability is higher than neighbouring countries. Obviously, the higher GDP per head would be reflected in a higher purchase ability compared to neighbouring countries. The high consumption could be noted as well in the size of the imports of Lebanon as opposed to the imports of its neighbours. Lebanon imported more than Syria and Jordan in 1997, while the value of its imports was over half that of Egypt's imports in the same year.<sup>453</sup> It is true that the high level of imports is partly a result of the lack of industrialisation in Lebanon. However, it is still remarkable to find that Lebanon - with a population around 4 million- imports over half the value of Egypt's imports, the population of which is around 60 million. The World Bank data on purchasing power parity and private consumption per capita shows how the Lebanese market is higher in consumption.

**Table 6.2 Comparative economic indicators from Lebanon and neighbouring countries**

Country	Private consumption per capita Average annual growth % 1990-97	Imports c.i.f. 1997 US\$ m
Lebanon	5.8	7,455
Syria	-0.6	4,018.8
Jordan	0.5	4,103.2
Egypt	2.1	13,210

Sources: for Private consumption and PPP figures, World Bank Atlas, 1998 & 1999. pp. 24 & 42. Imports' figures are derived from the Statistical Abstract of the ESCWA Region. Eighteenth Edition (UN, 1998) pp 396 - 397.

<sup>452</sup> EIU country profiles. 1999-2000.

<sup>453</sup> Statistical Abstract of the ESCWA Region. Eighteenth Edition (UN, 1998) pp 396 - 397.

- The low taxes when a company reaches a profitable situation. "It is better than Europe but not as good as the Gulf. A sort of half way house", Wright said. The Hariri government slashed taxes down to a maximum of 10 per cent on personal and corporate incomes. Therefore, as far as taxes are concerned it is far cheaper to operate in Lebanon as opposed to EU countries where taxation is at least double these figures. However, business operations in Dubai do not face any kind of income taxation. Only custom duties are imposed on imported goods.

#### **6.2.1.2. Obstacles for FDI according to Inchcape's experience**

Inchcape's manager in Lebanon was not impressed by the trade barriers being imposed during the period of their commencement of operations. He was surprised by these changes "when Lebanon was known for free trade while barriers are well known to hurt trade". Mr. Wright was referring to trade barriers imposed by the Ministry of Agriculture against some products that compete with similar produce of Lebanon. He raised the issue of banning imports of apples. He agreed that the quality of apples produced in Lebanon is acceptable. However, he thinks that the standards of picking, packing and storing are poor which shortens the life of the product. "We said that at the right season we would be selling that kind of product because it is the right quality and price at the time but when it is off season we want to import it." Apparently, the Ministry of Agriculture considers that the excess of apple produce (146 000 Tons in 1996)<sup>454</sup> should be accompanied by a ban on imports all around the year. Mr. Wright feared facing losses because of this policy: "The fact that you can't sell them (apples) because they are in a bad condition means a total loss." When it was suggested that consumers might be used to such qualities, his reply was: "We want to bring Lebanon to higher standards. It has fallen back far enough in the 17-years war. It needs to bring itself up and not to put up with this standard because it is not war time anymore".

Lebanon's joining of treaties like the GATT and Euro-Med partnership did not seem to reduce the Inchcape-Lebanon manager's fears. He complained that in the last year only (1995-96), there were three increases in custom duties. "More and more things are banned continually, and it is going to be difficult to bring anything in." He disagreed with the assumption that such barriers promote local industry and agriculture

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<sup>454</sup> EIU Country Profile 1999-2000. p.38.

"Everybody around the world know that it does not work." In such cases, local businesses do not invest and markets never grow, he asserted.

Vegetable and fruit products seemed to be crucial on Spinneys' list of products. Mr. Wright defended his disagreement with bans on agricultural imports by saying they are a major part of their envisaged stock. "Without it there is not much space for profit. It is a very low profit environment here in Lebanon." He emphasised that the margins for profit are very slim and the only way to achieve profit is through volume and offering variety of products. He considered that the players in the Lebanese market have no expertise in retailing, and all they do is cut prices against each other to draw customers: "They cannot get them through service, quality or fresh fruits, or range, because they cannot do all these things." In that sense he emphasised his company's superiority in retailing against its local counterparts: "We can, plus we can do the price".

He warned that restrictions could change the positive assumptions that brought investors like his company into Lebanon. He commented that to conduct retailing business in an environment saturated with import restriction was easier in markets with bigger populations. Syria was the example he provided. When faced by the fact that the consumer purchase ability in Syria is much less than its counterpart in Lebanon, he insisted that "a big store in Damascus would do every bit as well as a big store in Beirut".

The major problems which foreign investors seem to encounter with bureaucracy in developing countries did not seem of particular concern to Inchcape in Lebanon. This does not mean that problems with the administration do not exist. However, these problems were still minimal, according to Mr. Wright, when compared to potential problems in neighbouring countries. At least, problems that had erupted so far would not stop Inchcape from going ahead with its investment. Mr. Wright noted, however, that this is one of the reasons why this supermarket is considered to be a pilot project, before going ahead with bigger investment: "we check if all our assumptions are correct all the way along before we plough on and invest in other stores".

Another problem that faces FDI in developing countries is the red tape or bribery that has to be paid to officials who could hinder the process of starting up a business. It works out in many cases as hidden-taxes that businesses have to pay in order to avoid harassment from officials. Mr. Wright states that "strangely enough," it was not much.

This meant that it did exist but in very petty ways: “petty officials here and there occasionally cause some problems, but not to the business as a whole”. He asserted that it was less than anticipated. When asked whether any influential figures had tried to cause trouble in order to gain partnerships in their project, Mr. Wright stated that many wanted to partner with Inchcape but no pressure was exerted.

As for government incentives, usually countries that want to attract FDI present a package of incentives to draw the attention of foreign businesses. In the case of Inchcape in Lebanon, Mr. Wright said that there had been no active encouragement. He considered the ministries of finance and economy as being helpful only because they did not present any obstacles so far. The only obstacle came from the Ministry of Agriculture concerning barriers on imports of agricultural goods.

#### **6.2.1.3 Inchcape’s plans for the future**

Spinneys is pursuing a programme with farmers to grow some products locally. One of these products is apples. The programme’s aim is to produce according to the accepted standards for exports; the same standard that Spinneys looks for in the products they want to sell in their stores in Lebanon. This produce would be used by their stores in the country, but also exported to their operations in the Gulf region. This was the major reason for the dispute with the Ministry of Agriculture, which was discussed earlier. Inchcape-Lebanon asked for permit to import apples with the said qualification until their farming programme yielded results.

Other plans concerning expanding their operations within the Lebanese market in the future were mentioned earlier. The company has the go ahead from Inchcape for seven supermarkets. However, this all depends on the result of the pilot project.

When asked whether Inchcape could consider using Beirut as its regional headquarters Mr. Wright did not reject the idea if the region was confined to the Levant. However, when it comes to the interior Arab region, he confirmed that Dubai is the hub today; “That is where our regional office is, and our two largest companies, Spinneys Dubai and our sister company MMI Dubai”. He hoped that Beirut would regain some of its role but noted that it’s a long way to go while Dubai “accelerates in modernisation”. He

confirmed that many of the questions about problems for investment would never be asked in Dubai.

Inchcape, which was about to start operations at the time these information were collected, planned to employ 220 staff members in Beirut, 211 of whom were to be local employees. Mr. Wright said that his company wants to integrate the local community: "Our policy is: as many Lebanese as possible." Concerning salaries, Inchcape pays the market rate as they believe that it would be impossible to compete while having a higher cost base than the others. Mr. Wright considered that Inchcape has already got higher costs because it "plays by the rules". He meant that the company declares all its employees with the authorities, pays the social security, and pays the full salary- not part of it. Here, he was referring to some firms that do not pay their employees full salaries, and others that avoid registering their employees with the social security departments to cut their costs. This deprives the employee of many social benefits.

When Inchcape (Spinneys) started operating in Lebanon it entered the market challenging all its competitors by introducing hugely reduced prices. This created a massive outcry from other supermarkets in Lebanon who complained to the Ministry of Economy and Commerce, asking them to curb Spinneys competitive activities. However, the Ministry had allowed Spinneys to offer some products at below cost prices. This concession was for a limited period though.

In an interview with a Lebanese newspaper, Inchcape-Lebanon's general manager, Michael Wright, repeated what he said about competition in the Lebanese market. He said that after a year of operation the market was very competitive, more than other markets in the region. However, he added that Spinneys had established itself as a benchmark for having the lowest prices in the region.<sup>455</sup> The customer count is about 8,000 paying customers in a good day. However, figures on profit are not available. "We are not a public company so we do not have to reveal figures", Mr. Wright said.<sup>456</sup> He revealed that on average, out of 600 top-selling items, only about 50 items are marked at a profit. The rest is sold at cost.

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<sup>455</sup> DailyStar, Lebanese English daily . A year after the rebirth of Spinneys, (Beirut 27 October 1999).

<sup>456</sup> Ibid.

The claimed success did not stop Mr. Wright from complaining about some governmental measures. While his complaints were confined to the Ministry of Agriculture when he was interviewed for this thesis, a year later he expressed his frustration about the competition policy of the Ministry of Economy and Commerce. He told the newspaper that the ministry was not prepared to allow a free market to develop. "He said that when he was selling bread at a price no one could match the ministry sent inspectors to the bakery and forced the business to raise the price it charged the supermarket".<sup>457</sup> Wright claimed that Spinneys could afford small margins of profit as they have a big volume of sales. For example, Spinneys sold 300,000 bottles of shampoo, he revealed. Spinneys is using the UK Tesco products which have achieved a high score of sales.

The pilot project seems to have convinced Spinneys to carry on with the expansion plan. Four other outlets are to be opened. The first is to open in Jnah in Beirut in 2000-2001 (Part of this area is known as Spinneys after the traditional location of a Spinneys store before the civil war). The issue of the exact site is not solved yet. Three other shops are planned to follow in Achrafieh, Jounieh and the Central District of Beirut (if a site is provided). The total investment for this expansion plan is US\$ 35 m. However, this includes the amount to be invested by landowners to develop the sites.

A major change occurred during this year as Inchcape Middle East Group has sold off its Spinneys brand with its stores and distribution business in the Gulf to Cupola. The new owner is an investment group in Dubai run by Pakistani executives and backed by Saudi money. The deal was valued at US\$ 116 m. A green light for the expansion of their retailing business in Lebanon was given by the new owner, while the managing team was asked to carry on with the job. Spinneys expect to create 1,000 new jobs once the new stores open.<sup>458</sup> Inchcape's belief in the future of retail in the Middle East did not seem to live long enough. According to the parent-firm publications, Inchcape announced in March 1998 that it would focus exclusively on its international motors operations in the future. The firm asserted that this has been the largest and most successful part of the Group. As a result, Inchcape sold its Bottling businesses in South America and Russia, its Marketing Services businesses in Asia Pacific and the Middle East, its global Shipping Services business, and its Asia Pacific Office Automation

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<sup>457</sup> DailyStar, Lebanese English daily . A year after the rebirth of Spinneys, op.cit.

business. From 1 July 1999, Inchcape became a Motors-only firm.<sup>459</sup> However, Inchcape did not leave the Middle East by selling its marketing services in the region. It is still operating in the Middle East as a distributor of motor vehicles.

## **6.2.2 Other EU firms in retail**

### **6.2.2.1 Ecomax SAL**

This firm was registered in Beirut as a local subsidiary of the French Ecomax after 1993. It is a Paris-based chain of supermarkets owned by Primisteres Reynoird, its mother company in France. However, Ecomax's main operations are in the French West Indies where it has a chain of 45 cut-price stores selling a basic range of essential items supplied in no-name packaging from its mother company in France.<sup>460</sup> Ecomax opened 13 retail outlets in Lebanon in 1996. It has been operating for 30 years in the Caribbean and wanted to export its style of shopping to Lebanon after deciding that the size of the country and its population which needed competitively priced food items would provide the perfect commercial environment.<sup>461</sup>

The difference between the case of Ecomax and Inchcape's Spinneys is that the former specialised in low-cost unbranded goods. Ecomax also started operating two years before Spinneys. However, Ecomax's experience with the Lebanese market did not flow as its management expected. The little-known brands did not seem to appeal to a "label-conscious Lebanese consumer".<sup>462</sup> The dire financial situation of many Lebanese does not apparently stop them from wanting well-known brands despite the higher cost. "People here still think that cheap equals poor quality, even though we made our savings on shipping, freight and cutting out middlemen," said Jean-Pierre Deguille, the director of Ecomax in Lebanon.<sup>463</sup>

Two major problems faced Ecomax after its arrival in Lebanon. First, it was seen as a threat to the local supermarkets that started squeezing the newcomer. The second is the

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<sup>458</sup> DailyStar, Lebanese English daily. [A year after the rebirth of Spinneys](#), op.cit.

<sup>459</sup> Inchcape's web page:

[http://www.inchcape.com/code/Browse\\_Code/default.asp?department=linkdata\\_inchcape&majorid=1&minorid=1](http://www.inchcape.com/code/Browse_Code/default.asp?department=linkdata_inchcape&majorid=1&minorid=1)

<sup>460</sup> The DailyStar, op.cit. 18, February 1999.

<sup>461</sup> Ibid.

<sup>462</sup> Ibid. 3, February 1999.

<sup>463</sup> Ibid. 18, February 1999.



delay and interference caused by the Customs and the Ministry of Economy, which did not seem to affect local businesses. This intensified when Ecomax noted that the unknown products were not appealing to the Lebanese consumer and decided to sell famous brands. Ecomax had to deal with local wholesalers whose high prices left Ecomax with very slim margins for profit. Moreover, Deguille claimed that many wholesalers refused to sell to Ecomax as they were threatened with a boycott by local supermarkets. "It's a jungle. If you're big and powerful you can do that, you can break the laws. That's a big problem in Lebanon," he asserted.<sup>464</sup> It was then that Ecomax decided to import its own famous-brands from France through its parent-firm. However, they were caught by the "petty bureaucracy" at the Customs and the Ministry of Economy and Trade, which caused them discriminating delays. Ivar Quarante, the finance director at Ecomax told local reporters that they brought in a consignment of concentrated milk from Nestle and they were asked by the Customs for a certificate from the French Ministry of Health to prove that they had the capacity to produce milk products. "It was crazy. You might as well ask Ford if they have the capacity to make cars," he commented.<sup>465</sup> Quarante added that Ecomax refused to pay bribes to ease the trouble with the Customs as it is not their policy.

Ecomax has decided to divest its business in Lebanon. After losing US\$ 15 m in two years it has closed nine out of its 13 outlets while the remained four were clearing their stocks by winter 1999.<sup>466</sup> The Ecomax executives have noted that "it is easy to invest in Lebanon but much harder to operate". However, they admitted that they have learnt a lesson in Lebanon after they were absolutely sure that their style of West Indies business was going to flourish in Lebanon. "Maybe if we'd spent more time looking at the market things would have been different. We have to recognise the mistakes we made here," said Deguille.

The case of Ecomax highlights the risk that is normally taken by a firm once it decides to establish operation in a foreign market. The local fierce competition and the lack of knowledge of the market could lead to astronomical losses and the failure of the business. It also sheds a light on the particularity of the Lebanese market in which consumers are so 'loyal' to celebrated brands, which are normally Western. As the

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<sup>464</sup> DailyStar, op.cit. 18, February 1999, op.cit.

<sup>465</sup> Ibid.

<sup>466</sup> Ibid.

Westernised mentality of the people encouraged Inchcape to invest in Lebanon, the same mentality seems to have contributed largely to the failure of Ecomax. Although the sale of less-known brands was common in European countries, the Lebanese consumer was not yet familiar with such concepts. The brand would not sound Western if it had an obscure name, unlike Nestle, for instance. The Lebanese consumer needed to be taken into that concept gradually. Ecomax claimed to have achieved some progress once they showed the differences in prices between branded and unbranded products on the same shelf. However, the other obstacles created by the red tape and corruption in bureaucracy are alarming as they seem to have destroyed the chances of Ecomax to recover and compete. The case of Ecomax could perfectly serve as a discouragement for any FDI venture in the retailing sector in Lebanon.

#### **6.2.2.2 BHV/Monoprix**

The Lebanese Admic brought the famous French brands of BHV (Bazaar de l'Hôtel de Ville) and MonoPrix. Like Inchcape, the motive for the investment in BHV was the westernised characteristic of the Lebanese population. The Chairman of Admic (the local franchisee) said that BHV's parent-firm, Galleries Lafayette and himself decided two years earlier that Beirut had the potential for a one-stop-shopping mega-store. Western retailers, he added, have many opportunities in Lebanon because people are open to the outside world, and many of them are French and English speakers.<sup>467</sup>

The opening of MonoPrix followed that of BHV after six months. The latter, inaugurated in December 1998, is a DIY store and the first to be opened outside France. Abshee, chairman of Admic, commented that BHV did not accommodate for all customers' needs. Hence, the idea of opening MonoPrix, which is a supermarket specialised in food and related products. The quality of the consumers played an important role in introducing MonoPrix as well. Abshee commented that many Lebanese lived in France during the civil war and are familiar with MonoPrix's brand.<sup>468</sup>

Unlike Inchcape's Spinneys, BHV and MonoPrix are franchises from their parent-firms to Admic, a local investing firm. The invested capital was around US\$ 35 m, and was

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<sup>467</sup> The DailyStar, op.cit. 21, December 1998.

<sup>468</sup> The DailyStar. 31, May 1999.

secured by the local firm through a Lebanese finance firm (Lebanon Invest). Admic faced problems in raising finance from the local market. Abshee expressed his firm's disappointment through negotiations with Lebanese banks as they asked for collateral against any loans.<sup>469</sup> Spinneys did not declare facing such problem of financing. This can be attributed to the fact that the parent-firm had met the cost of investment.

### **6.2.3 Trade and FDI**

The case study of the retailing sector proved that the British firm Inchcape made an FDI move into Lebanon when it decided to open Spinneys supermarkets. It committed a certain amount of capital to go ahead with a project that it must have considered feasible. It can be argued that the history of Spinneys in Lebanon before the war made Inchcape, who had no history in Lebanon before, interested in inspecting the niche for business in the country. The fact that Spinneys had a long-established name before the war reduced the risks of entering a new market for the first time. Ecomax operations in Lebanon resembled those of Inchcape's in the sense that the two firms have conducted FDI. Both companies divested their businesses during the period that falls outside the scope of this research. However, the act of divestment is not identical in the two firms. Ecomax has terminated its operations in Lebanon completely owing to the cumbersome losses they endured, while Inchcape's divestment in Lebanon was a result of the company's decision to withdraw from the whole business of retailing worldwide. Inchcape also found a buyer for its business that had no symptoms of failure, either in Lebanon or in the Middle East. The fact that the policy of expanding in Lebanon has been adopted by the new owner of Spinneys proves that the pilot project had given satisfying results.

Nevertheless, when the cases of Inchcape (Spinneys) and Ecomax are compared with other retailing projects we find that not all foreign supermarkets or department stores in Lebanon can be considered FDI. The case of MonoPrix could be one of these examples. There is no denying that MonoPrix is a French supermarket. However, the company that brought it to Lebanon is Admic, which is a local firm. The capital invested in MonoPrix and its sister store BHV (US\$ 35 m) was raised by Admic through debt and equity.

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<sup>469</sup> The DailyStar. 21, December 1998.

There is no evidence that the parent-firm had invested any capital in the project. To this end, we could say that those two projects are pure franchises in which the foreign firm gives the investing firm the right to use its name. The return would be either through buying products from the parent-firm or by paying a certain price for the brand. In this sense, it does not differ from any of the big multinational names that could be found in Lebanon, like McDonald's, KFC, and recently, Burger King.

Apart from retail, other trade business activities that EU firms were involved in were merely export-import trade. More precisely, most of them were representative offices to market for their products that are produced abroad. This is the case of Adidas Sarragan of France and Smithkline Beecham of the UK, for example. Moreover, given the chronic deficit in Lebanon's balance of trade, particularly with EU countries, we could anticipate the trend of trade conducted by these representative offices. These also cannot be considered FDI as they are in the country to promote their products, not to produce them in Lebanon. In other words, their business results in an outflow of capital from Lebanon without much coming in return.

**Table 6.3 Lebanon's external trade with some EU countries in 1996**

1996	Italy	France	Germany	UK
Imports US\$ m	846.03	545.38	594.32	279.68
Per. of total	12.1 %	7.8 %	8.5 %	4.0 %
Exports US\$ m	49.33	55.59	24.27	18.79
Per. of total	6.3 %	7.1 %	3.0 %	2.4 %
Deficit US\$ m	-796.7	-489.79	-570.05	-260.89

*Source: IMF, Back to the future: Postwar Reconstruction and Stabilisation in Lebanon.*

#### **6.2.3.1 What the theory of FDI says**

To understand fully the status of EU firms activities in Lebanon, it is better to go back to the criteria stipulated by the theories of FDI discussed in earlier chapters. In the retail sector and other sectors, the theories of foreign direct investment can help to highlight the differences between investing firms and others who are conducting different types of business.

International investments have been explained as the movement of factors of production between countries rather than the movement of goods and services only. The latter can be called international trade. International investment includes the transfer of productive resources like capital, technology and labour.<sup>470</sup> Moreover, we have already explained in the theoretical chapter, that in order to differentiate between portfolio and direct international investments, something else next to capital must be involved in the latter. Dunning said that this could simply be informal managerial and technical guidance. In addition, a dissemination of valuable knowledge in the form of research and development, production technology, marketing skills and managerial expertise could be incorporated.<sup>471</sup> That is apart from the issue of control over the invested in unit which Hymer and Dunning stipulated. They asserted that direct investment means an exerted control by the investing firm over the invested in unit.<sup>472</sup>

Therefore, to assess whether EU firms that are conducting business in Lebanon are involved in FDI or not, we should apply the theory to the EU firms chosen for this research and investigate whether the criteria for FDI are available in these firms. These criteria could be divided into the four activities that the firm should be exercising: transfer of capital into the host country; transfer of technology into the branch in the host country; transfer of know-how (marketing skills, managerial expertise...etc.); and exerting control on the subsidiary in the host country.

#### **6.2.3.2 The theory of FDI applied to EU firms in retail sector**

Going back to the retail sector, we will look at the cases of BHV / MonoPrix, Inchcape, and Ecomax. Certain criteria for FDI have been established here depending on the conditions stipulated by the theories of foreign direct investment. The following table will help to examine the case of these firms according to the criteria provided by the theories of FDI.

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<sup>470</sup> Czinkota. M, op.cit, p.26.

<sup>471</sup> Dunning, J, (1970).op.cit, p.4.

<sup>472</sup> Ibid.

Hymer. S. H, op.cit, p.1.

**Table 6.4** Retail activities according to FDI criteria

Criteria	BHV / MonoPrix	Inchcape	Ecomax
Capital transfer	No	Yes	Yes
Technology transfer	Yes	Yes	Yes
Know-how transfer	Yes	Yes	Yes
Exerting control	No	Yes	Yes

In the case of MonoPrix / BHV, there is no evidence that the parent-firm invested any capital in the Lebanese branch. The investing local firm raised the money. Once there is no capital invested in a business then, clearly, there is no investment. The definition of FDI concerning the issue of capital is adequately clear in the dictionaries of economic terms:

*"The acquisition by residents of a country of real assets abroad. This may be done by remitting money abroad to be spent on acquiring land, constructing buildings, mines, or machinery, or buying existing foreign businesses".*<sup>473</sup>

The issue of money is clearly emphasised in the definition. Therefore, once it is established that a parent-firm did not invest any capital in the newly established business, then it should not be considered FDI. Other factors determining whether the business conducted is FDI or not become secondary or irrelevant to the case.

The business we are talking about then is pure franchise. The case of this is identical to the case of McDonald's. No capital was evidently invested by the McDonald's parent-firm. The investment came from a local investor who acquired the franchise. Technology transfer is not the same size in retail industry as in manufacturing. However, it is still essential. Even the way the retail firm manipulates Information Technology can be considered as a technology transfer if this was available to the subsidiary. Computing programmes that were developed by (or for) the parent-firm can be considered as technology transfer once disseminated to the subsidiary or the franchisee in the host country. The same is true of the transfer of know-how. This could include, in this context, instructions that range from displaying products to stock-taking, advertising and management. The concept of know-how would be extended to the

<sup>473</sup>Black, J, Oxford Dictionary of Economics. (Oxford University Press: 1997) p.183.

details of production process in manufacturing. It is normally the outcome of the research and development process conducted in the parent-firm. However, the transfer of technology and know-how without capital is still not foreign direct investment. McDonald's' parent-firm seems not to see a problem in transferring the know-how to its franchises worldwide. BHV or MonoPrix obviously seem to be in the same situation. The proposal submitted by the local firm must have been economically feasible to the parent-firm in which the return is worth giving the brand name to the franchisee. Indeed, the Internalisation Theory of Foreign Direct Investment stipulated that unwillingness to pass the know-how to another firm abroad leads a parent-firm to invest abroad.<sup>474</sup> A firm's desire to keep its knowledge of a product exclusive would be threatened through franchising. This could motivate the firm to invest directly in the host country keeping its know-how within.

Obviously, the cases of Inchcape (Spinneys) or Ecomax are completely different. The parent-firm decided to invest a certain amount of capital in starting operations in Lebanon. Around US\$ 6 m was invested by Inchcape in order to open its retailing outlet pilot project, Spinneys (figures on Ecomax's invested capital are not available).<sup>475</sup> The major component of foreign investment, the capital, is there. Moreover, this foreign investment should be called direct because the parent-firm is exerting control over the subsidiary. The parent-firm's expatriate team manages it. Thus, the fourth factor that was missing in the cases of BHV/Monoprix and McDonald's is available here. The control by a parent-firm over its franchise is confined to supervision in order to maintain the reputation of its product.<sup>476</sup> Looking at other factors stipulated as criteria for FDI, transfer of technology and know-how, these were surely fulfilled. The company made a decision to invest in retailing in Lebanon, which in other words means competing with the already existing supermarkets. When Inchcape representative says "we want to bring Lebanon to higher standards (in retailing)" and that "supermarkets here (in Lebanon) are still 20 years behind"<sup>477</sup> it means that Inchcape is up to competition. To compete with the local supermarkets, Inchcape would have to use its advantages in the retailing industry. This could be explained by the Monopolistic Theory and Market Imperfection Theory of FDI: the firm believes itself to have a

<sup>474</sup> Rugman, A, 1988. op.cit. p.104.

<sup>475</sup> Author's interview with Inchcape manager in Lebanon. op.cit.

<sup>476</sup> Black, J, *Oxford Dictionary of Economics*. op.cit, p.186.

monopolistic advantage in an imperfect market where others do not have it. A decision to move into the market to exploit that advantage makes sense.<sup>478</sup>

### **6.2.3.3 Size of FDI activities conducted by EU firms in retail**

It is striking to find that FDI activities conducted by EU firms in the retail sector in Lebanon were very minimal. Only the British Inchcape and French Ecomax qualified for the criteria of FDI. The number of foreign supermarkets in Lebanon is not very big. Local supermarkets outnumber foreign operators. By now we can say that the divestment of Ecomax and the subsequent sale of Spinneys by Inchcape have emptied the Lebanese market of EU operators of supermarkets. Other retail businesses can be noticed in Beirut shopping centres like the British Next, Mothercare, and the Body Shop. However, these names did not show in any of the foreign-firms listings in Lebanon. It is very likely that these retail businesses resemble the case of the French MonoPrix and BHV, where a local firm has acquired the franchise from the parent-firm. The names of the shops are just the brands used by local investors.

## **6.3 Contracting**

This line of business activities proved to be the most popular amongst foreign firms, particularly EU firms, which came to Lebanon from 1993 onwards. Many of the EU firms that turned up bidding for contracts tendered by the government were quite big. Some ranked amongst the global top 500 companies. Obviously, many infrastructure rebuilding contracts were mouth-watering for these firms, hence the huge response.

This part of the thesis discusses the business of a selection of EU firms, which were successful in gaining contracts from the government. These are mentioned earlier within the discussion of the EU firms share in contracting. However, this part will be dedicated to show the level of involvement of these firms in Lebanon, and the firms' plans for future business in Lebanon. The detailed case study is of the British-based firm, Kvaerner (Trafalgar House). The other companies chosen are Siemens S A, Bouygues, Hochtief A G, and Ansaldo.

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<sup>477</sup> Author's interview with Inchcape general-manager in Lebanon. op.cit.

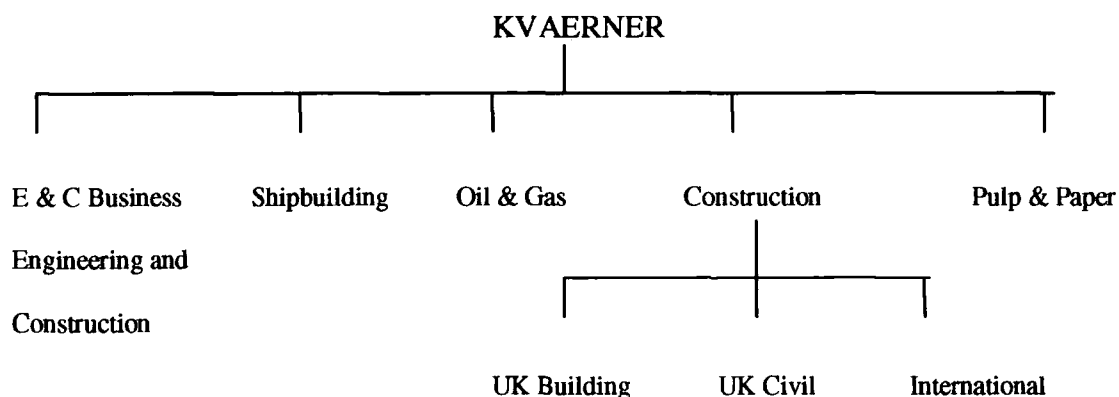
<sup>478</sup> Go back to theories of FDI: Monopolistic-Oligopolistic Advantage theory, and Market Imperfection theory (chapter 4).



### 6.3.1 Kvaerner Construction International –Beirut (Trafalgar House)

Kvaerner is in fact a Norwegian firm. However, two reasons contributed to the decision to discuss the case of its business operations in Lebanon. Firstly, although originally Norwegian, Kvaerner gained its place amongst big UK firms by its take-over of the British Trafalgar House. Kvaerner then moved its headquarters to London. Secondly, Trafalgar House was chosen as a case study after being awarded the contract to rebuild the Beirut Sports Complex, which was valued around US\$ 60 m. After it commenced the job, Trafalgar House in the UK was taken-over by Kvaerner.

According to Ken Gilder<sup>479</sup>, the project manager in Beirut, Kvaerner was an enormous Norwegian company that was four times the size of Trafalgar House and wanted an EU base. The feeling was that Norway was slightly cut off. They looked for companies to buy either in Germany or the UK. After the deal with Trafalgar House, Kvaerner moved its head office with the main board of directors to London. It now operates out of the UK while the bulk of its staff is British. Gilder said that the company is virtually British.



Source: Kvaerner's web page: [Http://www.kvaerner.com](http://www.kvaerner.com)

Kvaerner has got five divisions: Construction division; Engineering and Construction Business division; Pulp & Paper division; Oil & Gas division; and shipbuilding division<sup>480</sup>. Kvaerner's business in the Middle East comes under the construction division only. Lebanon is not the only country in the Middle East that hosts Kvaerner business. Gilder declared that at the same time Kvaerner had two construction projects

<sup>479</sup> Author's interview with Ken Gilder, project manager at Kvaerner Construction International – Beirut. August 1988, Beirut – Lebanon.

<sup>480</sup> Kvaerner's web page: <http://www.kvaerner.com>

in Egypt, and one in Dubai. In the latter, a subsidiary of Kvaerner, Cleveland Bridge, is involved in bridge building.

As mentioned earlier, Kvaerner was awarded the contract to rebuild the biggest sports complex in Lebanon. The complex was destroyed during the Israeli invasion in 1982. It was one of the biggest construction projects to be tendered out. One of the reasons why Kvaerner got the job, as Gilder explained, was that Kvaerner's chance was derived from the fact that the project was a "complex". He emphasised that this was normally the case for all projects taken by European firms: "if we were competing in the normal type of building, then I believe local contractors and others from other parts of the Middle East like Saudi Arabia would be more competitive". He emphasised that not many companies in the world could build stadiums, however.

When asked why he thought local and Arab contractors would be more competitive than foreigners in other types of construction contracts, Gilder confirmed that this was due to the cost. For "non-complex" projects, a local consultant like Dar al-Handasah would carry the design, for instance. "They are very capable of doing that." He said that this would be far cheaper than going to Europe to get a structural design for a stadium. Gilder emphasised that what really makes it viable for a foreign company to price a job is the fact that a local company could not do that. He recalled that most of the companies who had bid for this project were European.

#### **6.3.1.1 Incentives for Kvaerner to conduct business in Lebanon**

The first positive aspect of conducting business in Lebanon according to Kvaerner's project manager was the ease with which expatriates could be convinced to come to Lebanon. Gilder was referring here to expatriate engineers and supervisors who are essential for the company's business. "Those expatriates worked in other countries that are not very pleasant to be in." He noticed that expatriates could live "normal" lives in Lebanon without having to worry about any social restrictions like in some other Middle Eastern countries.

Another incentive was the promising size of the market that Kvaerner saw when it moved into Lebanon. They found a country needing reconstruction, which meant numerous opportunities. However, Gilder added that this did not necessarily turn out to be true, but that it was an incentive at the time.

Kvaerner did not face any problems in importing material. In that context, Gilder considered Lebanon much better than other countries in the region. Getting imported goods through the ports or airport in Beirut, although difficult by British standards, was much easier when compared to Saudi Arabia, Gilder said. Custom duties were very low when Kvaerner commenced work in Lebanon, Gilder noticed. However, they had subsequently increased significantly, he added.

Kvaerner enjoyed the abundance of Syrian cheap labour. The big labour supply was something that a construction company would certainly need.

#### **6.3.1.2 Difficulties faced by Kvaerner**

Dealing with the government administration and the CDR did not seem to please Kvaerner's manager in Lebanon. He complained about problems he faced with the administration and representatives of the government, causing delays at some times. However, he confirmed that it is understandable after 17 years of war that the government is trying to put its administration back together.

Another "big difficulty", according to Gilder, was in dealing with local consultants who were representing the client (i.e. the government). He complained that local engineers lacked the experience that is available in Britain, or "even in some parts of the Middle East". He said that some consultants, like Dar al-Handasah, worked abroad during the civil war, so they kept their business and experience developing. When they moved back they brought their acquired experience with them. Others, he complained, did not work abroad and thus they lacked the experience that European firms would be looking for. This, he said, created problems in dealing with government consultants.

Kvaerner was not put off doing business in Lebanon because of the red tape or bribery that sometimes has to be paid. Gilder commented that this is no different from any other part of the Middle East. "That is the way this part of the world works," he added. Problems might erupt but it did not hinder the business. Gilder considered that any businessman coming to this part of the world expecting no bribery is either totally innocent and naïve or "being a bit silly". He rejected the name "hidden-tax" because it is clearly there and one has got to act accordingly: "It is wrong but not hidden".

Problems arose in receiving regular payments from Kvaerner's client, the government. Gilder did complain about the delay in receiving payments. He said that it was becoming increasingly difficult. He stressed that they were sure they would receive the payment eventually. However, it is a problem, as contractors would be taking it into consideration when they price another job. Consequently, the price would certainly be higher.

#### **6.3.1.3 Contracting is the motive**

Kvaerner moved into Lebanon only because of this particular contract. Gilder asserted that although they wanted to explore other opportunities for business in the country, winning the contract was the major motive. He emphasised that construction companies do not move into a country to look for a job – "They find the job, then they move in and look for another one". At the time of this fieldwork, Kvaerner was in the process of looking for other business opportunities, as their present contract was nearly finished (in summer 1998). However, construction was Kvaerner's sole interest in Lebanon. The company was not interested in other sorts of business in Lebanon although the company itself has got other divisions next to construction. This can be purely due to Kvaerner's lack of interest in other fields of business in Lebanon. However, such a decision would certainly be affected by the availability of business opportunities. Obviously, Lebanon does not offer lucrative opportunities in the pulp and paper industry or in oil industry, in which Kvaerner is involved elsewhere. Only one section of Kvaerner was operating in Lebanon, the construction division. However, Kvaerner was interested in looking for more opportunities in contracting. Its team in Lebanon had priced some contracts during that period and they were waiting for a reply. If there were no more contracts for Kvaerner, the decision was to pull out upon the completion of the job.

On that same point, Gilder emphasised that they were interested in contracting only and had nothing to do with FDI. However, he noted that Kvaerner invested some capital for the commencement of works, expecting to recover it when the job is accomplished. The amount of money invested was not to be declared.

Kvaerner created opportunities for employment in the country, though. In addition to the expatriates, Kvaerner had Lebanese engineers, local administrative staff, and basic labour, mainly Syrian. At the peak of its operations, Kvaerner had about 1600 Syrian

workers, around 200 Lebanese (engineers and administrative) and about 30 Britons. About 70 per cent of the top-level supervision were British.

### **6.3.2 Other contracting EU firms**

At the same time as Kvaerner was operating in Lebanon, there were a substantial number of other contracting firms of EU origins. They were involved in a plethora of activities related to rebuilding infrastructure. The nature of these firms' activities is almost identical to that of Kvaerner – following the same pattern of contracting from the government. A brief discussion of the activities of some of these EU firms shows the resemblances and differences between all of them.

#### **6.3.2.1 Siemens SA**

Siemens is a giant German company specialising in telecommunications and electricity. It has been registered in Lebanon since 8<sup>th</sup> January 1994. Siemens' share of contracts tendered by the government was 4 contracts, most of which were quite substantial.

The first was in electricity, building a new power plant in the North, for a value of US\$ 274 m. The contract was signed in January 1995 for a period of 30 months. The second contract was to rehabilitate and extend exchange equipment for the public telephone landline network. It was valued at US\$ 33.68 m, signed in October 1993 for two years. The third contract was to rehabilitate and install new telephone lines, valued at US\$ 153 m. It was signed in September 1994 for three years. The last contract was a small one to supply equipment for interchange traffic. The value of the contract was US\$ 1.32 m. It was signed in February 1996 for a period of 4 months. Siemens also won private sector contracts providing equipment to the GSM network company FTML (Cellis).

#### **6.3.2.2 Bouygues**

Bouygues is a French company which has been registered twice in Lebanon under different statuses: the first time was on 16<sup>th</sup> March 1994 with business type stated as electricity and trade; the second was under Bouygues off-shore on 26<sup>th</sup> February 1997 with the business type declared being contracting.

Bouygues won one contract from the government in the electricity sector. It was for the rehabilitation of distribution networks in the regions. The contract was valued at US\$ 53 m. It was signed in November 1993, for a period of 18 months.

Another contract that Bouygues won was a prestigious job for the private company building the BCD, SOLIDERE.<sup>481</sup> Bouygues was assigned to build the marine defence for the seafront of Beirut. The value of the contract was US\$ 230 m. It was signed in mid-1996 and was expected to finish in 39 months.

#### **6.3.2.3 Hochtief A G**

Hochtief is a German firm whose business line declared in its registration in Beirut is construction. It was registered in Lebanon on 11<sup>th</sup> of December 1994. Hochtief received one of the biggest contracts awarded by the government. In a joint venture with the local/Athens based CCC, Hochtief snatched the contract to build the new Beirut International Airport. The value of the contract was US\$ 387 m. It was signed in September 1994 with a 4-year period to be finished.

#### **6.3.2.4 Ansaldo**

This is an Italian company that is specialised in electricity projects. It was registered in Lebanon as Ansaldo-Energia Spa in February 1996. However, this date seems a bit disputable, as Ansaldo has been conducting business in Lebanon since the end of 1993. Ansaldo gained two contracts in the electricity sector: the first was to rehabilitate power plants that belonged to EDL. The contract was valued at US\$ 106 m starting from October 1993 for a period of 18 months. The second contract was to build a new combined cycle power plant in Southern Lebanon. The value of this contract was around US\$ 260 m. It started in January 1995 for a period of 30 months. The two contacts were quite important. No record of other contracts has been traced.

### **6.3.3 Contracting and FDI**

By looking at the information discussed above we realise that these EU firms were contractors who came to do a job advertised by the government for a certain amount of millions of dollars. Differences between these firms were confined to the kind and value

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<sup>481</sup> Beirut Central District.

of their jobs, while the contract was the main common motive for their move into Lebanon. Had these contracts not come up, many of these firms would not have considered doing business in Lebanon. These firms' commitment to Lebanon is limited to finishing the contract on time, as long as the payments are coming through. Once the contract is finished, these firms would not have the intention to stay in the country one more day, unless another contract came up. One could argue that these firms have created job opportunities for the local labour force. That is completely true. However, another opposing argument says that the reconstruction projects themselves raised the opportunities for employing local labour, not the European firms. Had the contract been awarded to a local firm, the same labour force, more or less, would have been needed and thus work opportunities would be there. The major reason for the EU firms and other foreign counterparts seizing these contracts was that their offers were more competitive, price- or quality-wise. Another reason is the fact that some jobs could not have been done by local firms which were not qualified enough. Competition for contracts in electricity and telecom was almost amongst foreign firms only.

The only contracting business that could be considered to be direct investment is projects developed on B.O.T., D.B.O.T., and B.O.O. In such contracts, a firm, whether European or not, commits itself to invest an agreed amount of capital in a certain project which it would be given a concession to exploit for a certain period. This is the case of France Telecom when it took the concession of GSM phones in a joint venture with a local firm to establish FTML. It is also the case of Finnish Telecom when they were given another concession for GSM phones with a local partner in Libancell. The 'traditional' type of contracting, however, does not involve committing a certain amount capital for investment purposes.

#### **6.3.3.1 The theory of FDI applied to contracting**

The presence of giant EU firms in the post-civil war period was hailed by many as a real return of international business interest to Beirut. Inevitably, the sudden appearance of these foreign firms must have revived the hopes of the people who had not seen many foreigners in the past decade, and certainly not many foreign firms. Moreover, there was a common hope shared by the majority of Lebanese people, officials and common, that once the war was finished, foreign businesses and capital would flow abundantly into

Beirut. The presence of companies like Siemens, Clemessey, EDF, and Trafalgar House (Kvaerner) initially appeared to support that argument. However, as I have pointed out, these firms came for the simple reason of winning contracts tendered by the government. They are foreign businesses but not foreign direct investors. If we apply the criteria of FDI to some of the contracting firms we can pinpoint who is involved in investment and whose business is confined to contracting. We will look at the cases of Kvaerner (Trafalgar House), Siemens and France Telecom.

**Table 6.5 Contracting activities according to FDI criteria**

Criteria	Kvarnaer	Siemens	France Telecom
Capital transfer	No	No	Yes
Technology transfer	Not applicable	Not applicable	Yes
Know-how transfer	Not applicable	Not applicable	Yes
Exerting control	Not applicable	Not applicable	Yes

The cases of Kvaerner and Siemens are identical when it comes to the factor of capital transfer. Both of them have received contracts to participate in the rebuilding of Lebanon's infrastructure. Kvaerner, as we discussed earlier, took over Trafalgar House that won the contract to rebuild the Beirut Sports Complex for a total amount reaching US\$ 60 m. Siemens, with four contracts in electricity and telecom sectors, had a bigger share as its contracts mounted up to US\$ 462 m. That is apart from other contracts from the private sector.<sup>482</sup> The common factor between the two EU firms is that they commenced business in Lebanon upon winning contracts that they bid for. The value of contracts is the amount of money received by these firms in return for doing the job. The Lebanese government is the client who is paying for the job. Therefore, the two firms had not invested any capital on their behalf. Simply, they have done a job in return for which they were paid, or are being paid, their wages. Indeed, they have not established any subsidiaries into which they would have pumped capital. They have just accomplished the projects they were assigned.

The same goes to the factors for transfer of technology and know-how. We have seen the two factors not applicable to the case of Kvaerner and Siemens in Lebanon. The fact that they did not establish subsidiaries, or even franchises, in Lebanon makes no room

<sup>482</sup> Information already discussed in the previous chapter.



for any transfers. In other words, whom would they transfer technology to? A transfer of technology or know-how takes place when there is a process of production taking place in the host country. The reason for it is to transmit the results of research and development, conducted by the parent-firm in its home country, to the subsidiary or the franchise in order to produce an identical product. However, in the case of their business operations in Lebanon, Kvaerner and Siemens were not engaged in any production process. One might argue that the two firms transferred technology and know-how through bringing their advanced equipment and their expertise. However, although contracting firms brought technology and know-how, they have transferred ready-made products for which the government had to pay the price. It is true that Siemens brought advanced equipment for telephone networks and power plants. However, Siemens, who is involved in manufacturing these capital products, did not produce any of them in Lebanon, nor it did operate them. It has just installed them. One could argue that the installation of new equipment and, in some cases, teaching local labour how to operate them, is a kind of residual transfer of technology and know-how. However, the technology and know-how that are meant by FDI theories are intermediate intangible assets transmitted between the parent-firm and its subsidiary to affect the product itself. This does not seem to be fulfilled in the cases of contracting firms in Lebanon. Therefore, the theory that is applicable here is the theory of international trade rather than theory of FDI because these firms brought ready-made technology for which Lebanon paid full price. The theory of international trade deals with movement of goods and services between countries, unlike theories of international investment that deal with the movements of productive resources.<sup>483</sup>

The issue of control, the fourth factor, is also not applicable for the cases of those two firms as there is virtually nothing to control. We have already established that the two firms did not establish any production through subsidiaries or franchise, therefore, the question of control is completely irrelevant.

On the other hand, the case of France Telecom business in Lebanon is hugely different. The French company is involved in a joint venture with a local partner in operating the GSM phone system. Their company FTML is a branch of FTMI (France Telecom Mobiles International). It was founded in August 1994 with a capital of 30 millions

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<sup>483</sup> Czinkota. M, op.cit, p.26.

USD, held to 67% by FTMI and to 33% by the Lebanese group MIKATI.<sup>484</sup> FTML won one of the mobile phone BOT contracts given by the Ministry of Post and Telecommunication. Unlike Kvaerner and Siemens, France Telecom invested capital in FTML. Therefore, millions of dollars were invested by the parent-firm France Telecom. This way, the first condition for a business to be foreign investment (capital transfer) is fulfilled. The fact that the parent-firm owns 67 per cent of the firm means that the firm has a control over the subsidiary. Thus, France Telecom business is a direct investment. The firm has transferred technology and know-how to the Lebanon's subsidiary as it introduced the concept of mobile phones into Lebanon.

#### **6.3.3.2 Size of FDI activities conducted by EU firms in contracting**

It might seem redundant to investigate the proportion of contracting EU firms that could have been involved in FDI activities in Lebanon after we have established the crucial difference between the two types of business. Contracting is a short-term commitment by which the awarded firm commits itself to the accomplishment of a certain project for an agreed amount of price. Meanwhile, FDI is a long-term commitment by the investing firm, which allocates a certain amount of capital for the establishment of its operations in a host country. However, there are certain types of contracting businesses for which this distinction is inappropriate. These are the B.O.T. and D.B.O.T. Such contracts are different because the contracting firm would meet the entire financial cost of the project in return for the concession to operate the enterprise for an agreed period of time. The firm in this case is taking up the whole risk, which in fact might lead to a devastating loss of the investment in case the project failed. The Lebanese government has introduced a set of projects for the private sector to contract on a B.O.T. basis. Amongst EU firms involved in contracting only two companies are involved in B.O.T. contracts. Due to the fact that this type of business is different from the conventional contracting system they were classified separately. These two firms are France Telecom and Finnish Telecom. The business of these firms that was discussed earlier shows that they are in a different business when compared to the other contracting firms. However, no other EU firms are involved in B.O.T. contracts. The French Bouygues and Domez were about to sign a B.O.T. contract to build the Beirut-Damascus highway toll-road. However, they pulled out, as they did not reach a satisfying agreement with the government by which

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<sup>484</sup> <http://www.cellis.com.lb/cellis-eng/index.html>

the latter would provide guarantees for recouping the investment. Therefore, the proportion of FDI in the contracting line of business is confined to two EU firms only. The government has tendered many B.O.T. projects. However, the response of EU firms has been very poor. Obviously, the tendered projects that ranged from car parks to the building of industrial estates did not appeal to EU businesses. That could be partly due to the nature of the projects, which might have not appealed to the Europeans, and partly due a high risk involved concerning recouping the initial investment.

## **6.4 Finance**

The list of foreign firms registered in Lebanon after 1993 showed that the financial sector came third to construction and trade in the EU firms business interests in Lebanon. The number of EU finance firms coming into Lebanon amounted to 10 by the end of 1998. This number includes insurance firms and commercial and investment banks. The firms chosen to discuss here are: Paribas, Flemings, Commerz Bank and Schroders.

### **6.4.1 Schroders**

The Schroders Group was founded in the early 1800's. It is a leading international merchant and an investment banking group. Its activities cover a wide range of financial services including corporate finance, investment management, private equity, structured products and capital markets. It ranks amongst the largest 100 companies listed on the London Stock Exchange and has a total market capitalisation in excess of US\$ 7 bn.<sup>485</sup>

Schroders, according to the company publications, is an acknowledged leader in corporate finance and ranks among the top five companies globally in project finance, privatisation and cross-border European mergers and acquisitions. It is also one of the largest fund managers in the UK with total assets under management in excess of US\$ 176 bn, as of December 31<sup>st</sup> 1997.<sup>486</sup> Schroders has offices in over 30 countries.

Schroders Asseily Group represents Schroders in Lebanon. Indeed, it has been responsible for Schroders' business in the Middle East and North Africa since the early 1970s. This group includes: J Henry Schroder & Co SAL (Beirut); Schroder Asseily &

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<sup>485</sup> Schroders in the Middle East. A brief about Schroders and its partners in the Middle East obtained from their offices in Beirut. 1998. p. 2.

Co Limited (London); Schroder Asseily (Guernsey) Limited; and JHSC Management Limited (Cyprus). This group is a subsidiary of Schroders and provides a range of investment and corporate finance services for individual and institutional clients, with a particular focus on the needs of the region.<sup>487</sup> According to Roy Gardner, Schroders Asseily is 65 per cent owned by Schroders, while the remaining 35 per cent is owned by the local Asseily family.<sup>488</sup>

Schroders Asseily's primary activity in Lebanon is to provide financial advisory services to corporations operating in Lebanon. This includes local and foreign firms in Lebanon. The company advises its clients on how to raise finance, and sometimes raises finance itself on behalf of clients. But Schroders Asseily operations in Beirut are not confined to Lebanon because the Beirut office covers the Middle East and North Africa, as mentioned earlier. A secondary role of the Beirut office is the provision of investment management services to individuals. According to Mr. Gardner, Lebanese customers deposit their money with Schroders Asseily who manages it on fiduciary basis. The company invests the deposited capital in stocks, equities, and bonds all over the world through co-operation with Schroders- London, the parent company.

Dr Anthony Asseily who had been with Schroders since the 1960s, made the decision to start operations in Lebanon. Dr Anthony Asseily and his brother George Asseily, a leading industrialist in Lebanon, decided with Schroders in 1974 to form a joint venture, which would act as Schroders merchant banking subsidiary in the Middle East. Gardner commented that at that time there was only one city in the region that you could build in, and that was undoubtedly Beirut. Gardner confirmed that Beirut's office never closed during the war period. However, he admitted that during that period there would be a month of activities followed by years of nothing happening.

The decision to operate fully back in Beirut's office was made at the beginning of the reconstruction period. In 1994, the office restarted operating on a care and maintenance basis. Gardner himself was recruited from the Saudi American Bank in Riyadh in 1995. One of the reasons to restart operations from Beirut, he said that firstly, it was the obvious need for Lebanese banks and companies to increase their capital. Lebanese

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<sup>486</sup> *Schroders in the Middle East*, op.cit.

<sup>487</sup> Ibid.

<sup>488</sup> Author's interview with Roy Gardner, Assistant General Manager at Schroders Asseily- Beirut. August 1988. Beirut- Lebanon.

banks were completely under capitalised due to the devaluation of the Lebanese pound during the 1980s. Secondly, it was the fact that Beirut is a perfect place to be based in order to cover the Levant and the Gulf region.

#### **6.4.1.1 Incentives to be based in Beirut**

The geographical location of Beirut seemed to be of significant interest for the Schroders Asseily assistant general manager in Beirut. He considers that it is easy to cover Jordan, Egypt and Syria (once it opens) conveniently from Beirut. Being in the middle between Europe and the Gulf region enriches its locality advantage. He said that getting to Kuwait or Dubai from London, for instance, is a waste of two days unless taking an overnight flight. In comparison, he stressed that he could do his work normally in Beirut, Monday to Friday, then jump on a plane to Dubai where they would be starting their week. By Monday morning he could be back in his office in Beirut “without missing the beat. Highly convenient”.<sup>489</sup>

Another incentive for foreign businesses in Lebanon, according to Gardner, is the Lebanese people themselves. The skills and abilities that are available make Beirut a natural centre for financial services in the region, he stressed. Beirut has the potential to benefit from the many Lebanese working abroad in banks, financial institutions, insurance companies. These would love to come back and bring in new talent, he added.

#### **6.4.1.2 Is Schroders a foreign investor in Lebanon?**

In the sense that a foreign firm creates employment opportunities, brings capital into the country, generates money in the local economy, and transfers technology, Gardner absolutely agreed that Schroders is a foreign investor. The firm’s capital in Lebanon is not large - only LL 2 bn (US\$ 1.33 m). However, he stressed that the firm does not need it. The firm brings capital into the country by raising finance for local companies from abroad. The firm was employing only six people in Beirut, when the research was conducted. However, again he stressed that their operations in Beirut kept many employees in their jobs. As an example, he referred to a deal they arranged for the local bank, Banque du Crédit Populaire, in which Schroders Asseily drew US\$ 15 m of

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<sup>489</sup> Author’s interview with Roy Gardner, op.cit.

investments from Oman. This deal secured the jobs of 120 employees who were about to lose their jobs, as the bank would have gone into liquidation, he asserted.

Gardner added that his company is not a typical example of FDI. However, he believed that his company brought into Lebanon advanced financial techniques developed by Schrodgers. In return, the firm got the "natural entrepreneurial flair of the Lebanese", he believed. Schroder Asseily's job in Lebanon is to act as a catalyst that allows foreign capital to come to create jobs in the country.

#### **6.4.1.3 Deals arranged by Schroder Asseily**

Schroder Asseily has arranged deals within its financial advisory job ranging from acquisitions to finance-raising. These deals were not confined to the Lebanese market but reached other Arab countries. This proves that Schrodgers Asseily was using Beirut as a base for the region, not only Lebanon. Some of the recent deals included:

- Advising the buyers on the acquisition of a substantial interest in Lecico, the largest ceramic and tiles manufacturer in the Middle East.<sup>490</sup> Lecico have plants both in Lebanon and Egypt. The buyers were a Finish company (Santic OY Ltd) and a Lebanese one (Intage Holding Ltd).<sup>491</sup>
- Advising Olayan Saudi Holding Company on the acquisition of the food and commodities division of a privately owned Saudi Arabian company.
- Advising Cimenterie Nationale SAL, Lebanon's second largest cement manufacturer on the financing of a US\$ 100 m expansion. This was the largest debt financing for a Lebanese borrower involving the IFC.<sup>492</sup>
- Advising Davy International in respect of the financing of a US \$200 m direct reduction iron plant, falling within HADEED's expansion programme in Saudi Arabia.
- Advising two FTSE 100 companies on proposed acquisitions falling under the Egyptian privatisation programme.

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<sup>490</sup> Schrodgers in the Middle East. op.cit, p.9.

<sup>491</sup> Author's interview with Roy Gardner. op.cit.

<sup>492</sup> Schrodgers in the Middle East. op.cit, p.9.

- Advising on the reconstruction and re-capitalisation of Banque du Crédit Populaire in Lebanon. The company raised LL 23 bn (around US\$ 15 m) in equity from an Omani group to re-capitalise the bank.<sup>493</sup>
- Advising Société Nationale d'Assurance (SNA) to raise finance. Schroder Asseily brought in the French insurance company AGF (now taken-over by Alliance). AGF bought a 30 per cent stake in SNA, worth over US\$ 11 m.<sup>494</sup>
- Schroder Asseily arranged for the issuing of convertible bonds that financed the regional skiing resort at Faraiah, and raised finance for the SOFIL centre in Ashrafieh.<sup>495</sup>
- Schroder Asseily also acted as an advisor to the UK Ministry of Defence on the Saudi Arabian Economic Offset Programme.<sup>496</sup> The report describes the job as a unique initiative between the British and Saudi Governments to promote the development of the industrial base of Saudi Arabia through joint ventures between Saudi and foreign companies. In the context of this appointment, Schroder Asseily has been closely involved in the identification and development of a wide range of projects in the Kingdom. Total investments are expected to exceed US\$ 3 bn over the life of the programme.<sup>497</sup>

The number of employees working in Schroder Asseily office in Beirut was eight in total. These included an Assistant General Manager, three corporate finance officers (the company was in the process of recruiting another one), one accountant, and three support-staff.

The Assistant General Manager was the only foreigner in the office. The corporate finance officers were Lebanese nationals who had worked abroad, and the rest were local.

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<sup>493</sup> Author's interview with Roy Gardner. op.cit.

<sup>494</sup> Ibid

<sup>495</sup> Ibid.

<sup>496</sup> The date is not available but very likely to be in 1997 as most of the dates mentioned in the report go back to that year. Schrodgers in the Middle East. op.cit. p.9.

<sup>497</sup> Ibid.

## **6.4.2 Other finance firms**

Schroders is only one of the foreign names known in the financial sector in Lebanon. Numerous foreign finance firms have been active in the Lebanese market since 1994. However, the activities of these firms have varied. A brief discussion of some other firms' activities would help in establishing the common points and differences between the activities of foreign finance firms in Lebanon. Above all, it would help in finding out which activities can be considered as foreign direct investment.

### **6.4.2.1 Paribas Ltd**

The French bank is one of the big European banks with a worldwide presence. Its origins date back to 1872 with the founding of Banque de Paris et des Pays-Bas through a merger of Banque de Paris (founded in 1869) and Banque de Crédit et de Dépôts des Pays-Bas (created in 1863 in Amsterdam). Nowadays, it is organised around four core businesses: corporate and investment banking; asset management and banking services; retail financial services; and proprietary investments and real estate.<sup>498</sup> It was registered in Lebanon on April 1995. Paribas only has a representative office in Beirut. It has been active in brokering deals for bonds and GDR issuing by the government and private banks, respectively.

### **6.4.2.2 Commerzbank**

The origins of this German bank go back to February 1870, when predominantly Hanseatic merchants, merchant bankers and private bankers founded Commerz- und Disconto-Bank in Hamburg.<sup>499</sup> After World War II, the Allies ordered a break up of all banks in Western Germany into regional units. The successor institutions of Commerzbank were able to re-emerge and form a single company by 1958 and since 1965, Commerzbank has been represented in every large town and city in western Germany. Nowadays, Commerzbank is one of Germany's big three private-sector banks in Frankfurt and is engaged in both commercial and investment banking activities. Outside Germany, the bank has over 50 outlets in more than 40 countries.<sup>500</sup>

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<sup>498</sup> Paribas web page:

<http://www.paribas.com/Site/HomeDb2.nsf/FrMain?ReadForm&level=200.200&lang=EN>.

<sup>499</sup> Commerzbank web page: [http://www.commerzbank.com/navigate/hist\\_frm.htm](http://www.commerzbank.com/navigate/hist_frm.htm).

<sup>500</sup> Ibid.



Commerzbank decided to open a representative office in Beirut back in 1957. This was one of its first offices abroad.<sup>501</sup> However, as the shelling reached Commerzbank's office in Beirut, the bank decided to close its office temporarily in 1982. The bank carried on with its activities in Lebanon through a network of correspondents. With the beginning of the reconstruction process, Commerzbank decided in late 1994 to re-activate its representative office in Beirut "to be able to provide better service to the existing network of correspondent banks and clients".<sup>502</sup>

Commerzbank was the only German bank to participate in the Eurobond issues by the Lebanese government. In June 1997, Commerzbank was the first to launch a DEM Bond issue for the Lebanese government (DEM 250m, for 5 years). Moreover, Commerzbank participated in financing the reconstruction process by arranging finance for the power plants projects in Beddawi and Zahrani. Here also, Commerzbank was the first German bank to do so.<sup>503</sup>

#### **6.4.2.3 Flemings**

This is a London-based British bank that is well established as an international asset management and as an investment banking group. It has a network of offices in over 40 countries and over 7500 staff. Flemings' origins date back to 1873 when Robert Fleming, founder of the firm, set up the first investment trust in Scotland investing in the emerging market of the US. Robert Fleming & Co was established in 1932. Flemings is privately owned.<sup>504</sup>

Robert Fleming Holdings Ltd opened a representative office in Beirut in October 1995. This office was to cover the region of the Near East. They arranged for the issuing of Global Depository Receipts (GDR) by Banque Audi in November 1995. The US\$ 34 m issuing was the first international public equity to be issued by a Lebanese institution.<sup>505</sup> It can be assumed that the imminent deal then was an incentive to open the representative office as obviously negotiations for the deal should have started earlier than one month before (the difference between date of opening the office and issuing

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<sup>501</sup> Information collected through e-mail correspondence with Commerzbank office in Beirut. December 1999.

<sup>502</sup> Ibid.

<sup>503</sup> Ibid.

<sup>504</sup> Flemings web page: <http://www.flemings.com/world/index.htm>.

<sup>505</sup> Banque Audi: Winning position. Flemings Research, Banking, Lebanon. September 1997. p:4.

the international public equity). Another followed in 1997, when Banque Audi had its second GDR issue for raising up to US\$ 75 m.<sup>506</sup>

However, these seem to be the only deals that Flemings secured in Lebanon. Other deals of GDR issuing seemed to go to other competitors like Merrill Lynch. Flemings' representative in Beirut referred to poor relationship management by Flemings as a major reason for not doing well in Beirut. He considered the appointment of a junior representative, i.e. himself, being 25 when he arrived in Lebanon, was problematic when he had to deal with chairmen of local banks discussing their capital structures or how to fund new branches. The feeling was that he could only listen to that chairman who spent the last 40 years building his bank. He believed that a successful relationship for corporate finance and capital markets work should be managed at a senior level.<sup>507</sup> Merrill Lynch had a more experienced manager based in London (35-40 years old) who maintained the relationship with Lebanese clients. Another issue highlighted by the Flemings' representative was the solid network of private accounts that Merrill Lynch had in the Middle East. Unlike Flemings, Merrill Lynch had the ability to guarantee their issuing clients in Lebanon a quick placement of their securities. Herbert said that Merrill Lynch could easily present a list of private accounts over which they have the power to convince their holders that their new GDRs are worth investing in. Flemings had the placing power but all depended on the client whether to buy or not.<sup>508</sup>

The lack of business for Flemings might have been the reason for reducing their presence in Lebanon. After Herbert's resignation, the decision to second another representative to Lebanon was revised and representation was confined to a local employee who collects data and arranges appointments for visiting delegates. However, we have to bear in mind that stagnation in the economy was already prominent. That might have well contributed to Flemings' decision not to send a new and experienced representative to Lebanon and to serve the market through delegations only.

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<sup>506</sup> *Banque Audi: Winning position.op.cit.*

<sup>507</sup> Author's interview with Dominic Herbert, Flemings' representative in Beirut until summer 1998. July 1998.

<sup>508</sup> *Ibid.*

### **6.4.3 Finance and FDI**

This third line of business, finance, came third in popularity amongst EU firms registered in Lebanon after 1993. However, the figure of 10 firms involved in finance moving into Lebanon is not very impressive. Given the history of Beirut in financial services a better response would be expected. One should take into consideration, however, that some foreign and EU banks and finance firms were present in Lebanon before the war. Some of the banks kept operating in Lebanon, mainly those with local partners. Others kept a lower profile. Certainly, the civil war resulted in the exodus of numerous foreign firms from the country. However, those that did not flee officially (i.e. closing their offices permanently) were not counted amongst the returnees. This is the case of Schrodgers, for instance. The office was never closed permanently although business was virtually non-existent during long periods of turmoil. Life was injected again into Schrodgers' office in Beirut after the end of the civil war. Looking at the list of foreign banks operating in Lebanon we find the same result: many EU banks were never removed from the list. The French BNP (Banque Nationale de Paris) was still there. The British Bank of the Middle East, now part of HSBC, also did not close its operation in Lebanon. The finance firms that came into Lebanon were mostly firms that were never present in Lebanon before the war. The likes of Flemings and Paribas are good examples. Investment banking was not popular in Lebanon before the war. All foreign and local banks registered in Lebanon before the war were involved in traditional commercial banking. However, the war left many Lebanese banks and firms under-capitalised. It was an incentive for foreign finance houses to move in trying to sell their services to Lebanese clients. Also, the hopes of reviving the Lebanese Stock Exchange raised these firms' hopes of good deals in advising on restructuring and listing local companies.

Nevertheless, the question that needs to be answered is if these finance firms coming into Lebanon can be considered as conducting FDI. Most of these firms had opened a representative office upon arrival in Lebanon. Their expenditure is normally confined to the rent of their offices and salaries, in addition to other domestic spending. Investment banking firms play a role in raising finance for local firms and bring portfolio investment. They might also bring foreign investors into a merger and/or an acquisition deal. However, we could argue that they are not direct investors themselves. A viable

justification for this argument is that, although their presence might in many cases bring capital into the country, the capital invested is not theirs. Yet, this argument could be reversed once discussing the issue of other finance firms that have shown a bigger interest in the country. This interest could be represented by renting or buying bigger premises, bringing more expatriate employees and employing a substantial number of local labour force. HSBC Holding is a suitable example. Being the owners of the British Bank of the Middle East, HSBC bought in 1999 a new building in Beirut for the price of US\$ 13 m<sup>509</sup>. This amount of money has either been transferred from the parent-firm in London, or most likely been raised from the bank's profit from its operations in Lebanon. Whatever the case, the millions of dollars paid into the premises would certainly lead us to consider this move as FDI. The two examples come from the same line of business, finance. While there is a difference in the sort of service they provide (Flemings is specialised in investment banking while HSBC in Lebanon is involved mainly in commercial banking, in addition to investment banking and corporate finance), both are financial services. The difference between the two cases is the level of interest and commitment adding to it the difference in the business needs of each of the two firms.

#### **6.4.3.1 The theory of FDI applied to finance**

The application of FDI theories becomes more complicated when we start discussing the third line of business chosen for this research. The diversity of activities within finance which comprises commercial and investment banking, insurance firms, accountancy, financial consultancy and others does not make our task easier. We have seen already that it is difficult to distinguish between finance firms' activities that could be considered FDI and others that could not. An application of the criteria provided by the theories of FDI would help in drawing lines between different finance activities. The case of Flemings and Schroders will be addressed, in addition to the case of HSBC. Although HSBC's business in Lebanon did not start after 1993, the period that this thesis focuses on, their business activities were brought into this research to help in the analysis. Their decision to buy the new premises in 1999 falls beyond the period this thesis addresses, 1993-1998. However, as the news of it came while analysing the data

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<sup>509</sup> The DailyStar, op.cit. 18/6/99.

available, it was thought to be helpful in this particular analysis without disturbing the time limit.

## **6.6 Finance activities according to FDI criteria**

Criteria	Flemings	Schroders	HSBC
Capital transfer	Current expenditure only	Current expenditure only	Yes
Technology transfer	Not applicable	Not applicable	Possible
Know-how transfer	Yes	Yes	Yes
Exerting control	Yes	Yes	Yes

As in the previous cases, theories of international investments stipulate a movement of capital between countries, i.e. a transfer of one of the major productive resources, as Czinkota called it.<sup>510</sup> Such international movement of capital is usually motivated by an eagerness to maximise the profits. Hence the tendency to gravitate towards locations with higher rates of return.<sup>511</sup> Profit maximisation could be achieved through either portfolio investment or direct engagement in a production process. The latter means that a product would be developed in the host country for which capital investments would be essential.

One of the major problems facing us in applying the theories of FDI to finance firms is the fact that theories of foreign direct investment were developed mainly to explain the case of manufacturing industries. The rise of these theories in the 1960s was mainly to explain the motives behind the tendency amongst American manufacturing firms to establish production abroad. That is why we find that theories of international investment were based on theories of international trade. Therefore, service industries, including financial services, do not seem to be appropriately covered by these theories. However, although finance firms were not named as such in the theory, it is possible to find a compromise in which theories of FDI can be applied. The core element of the theory is the product. The firm has a specific product developed in its home country and exported to other countries. Once a decision to invest abroad is taken, it means that the product will be developed abroad. Indeed, it can be justifiably argued that services are products, as well. Financial services are intangible products developed by finance firms. Therefore, we could look at finance firms operations in a foreign country in a similar

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<sup>510</sup> Czinkota. M, op.cit, p.26.

way to manufacturing firms. As we have established earlier, capital transfer is essential for any foreign business operation to be considered foreign investment. Looking at the case of firms like Flemings and Schroders, the picture is quite different. Those two firms have got representative offices in Beirut. Both had a very limited number of employees, though Schroders was larger in that sense. Capital transfer in this context is confined to current expenditure as opposed to capital expenditure. Expenditure that is confined to salaries and rent cannot be considered investment although it is spent abroad. Once we compare these two cases to the case of HSBC we can easily notice the difference. HSBC had US\$ 13 m of expenditure only to purchase a new building in Beirut. There is capital investment involved here. HSBC has over two branches in Lebanon. This means inevitably extra capital expenditure.

A very useful way to differentiate investing finance firms from non-investing ones would be to divide them into two further categories: branches and representative offices. Those two terms came up in the previous paragraph. If you look back you will see that Flemings and Schroders have established representative offices in Beirut. Meanwhile, HSBC has got branches in Beirut. This leads us to investigate the type of business. If the case of representative offices is identical to the case of representative offices of trading firms, then the theory of international trade is more applicable. These finance firms are promoting their product, financial services, in foreign markets. Their representative offices are just bridgeheads to reach foreign markets in order to bring more business to their headquarters in London. So, if we consider the transfer of technology and know-how we could say that this has been a transfer of product straight to the market. On the other hand, branches have got a different role. The branches of HSBC in Beirut are operating much the same as local banks. They are involved in commercial banking, which means they have assets and liabilities in the Lebanese financial market. They are producing their service in Lebanon, and it would certainly sound sensible that any technology available for HSBC parent-firm would be transferred to its subsidiary in Lebanon if that would serve its competing position among commercial banks. The issue of control is not very difficult to assess in those cases. Representative offices are obviously controlled by the parent-firm. In the case of Schroders, as it is a result of a joint venture between Schroders – Asseily, Schroders

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<sup>511</sup> Czinkota. M, op.cit, p.26.

own 65 per cent of the joint venture which is based in London. However, as capital investment is not involved then the issue of control is not very relevant. Meanwhile, in the case of HSBC it is different. Lebanon's operations are controlled by the parent-firm, which appoints the executive positions in HSBC Lebanon.

The same style of categorising could be applied to other finance firms like insurance and accountancy. If the firm is establishing a representative office than the firm is not investing. However, if the firm is establishing a branch, and buying or merging with a local finance firm so that capital expenditure is involved, then this firm is a direct investor.

#### **6.4.3.2 Size of FDI activities conducted by EU firms in finance**

Tracing FDI activities by EU firms becomes immensely difficult when we reach the finance sector. It is already obvious from the above analysis that drawing a line between the investment and non-investment activities of finance firms in Lebanon is hard enough. The combination of the criterion of capital transfer and consequent condition of operating as a branch or merger with a local firm excludes all finance EU firms registered between 1993-98 from the FDI category. They have either established representative offices, or have given no indication of capital transfer from the parent-firm to the subsidiary in Lebanon. HSBC was not registered amongst the newly incoming finance firms. In this sense, its case is identical to the case of other European banks that already existed before the beginning of the reconstruction period. These included *Crédit Lyonnais France SA* as the owner of over 66 per cent of the shares in *Crédit Lyonnais Liban SAL*, which was established in 1951. Also included is *Banque Libano-Francaise* in which *Banque Indosuez* owned 51 per cent of the shares; *Banque Nationale de Paris Intercontinentale* with *BNP* owning over 80 per cent of it since its establishment in 1944; and the Dutch *ABN Amro* that has been established since 1954 with four branches operated by 141 employees<sup>512</sup>. However, one European insurance firm, the French *AGF*, has entered the Lebanese market in 1997 through buying 30 per cent of the Lebanese insurance firm *SNA*. The amount of *AGF*'s investment was announced as US \$11 m. This investment move can be considered to be FDI as 30 per

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<sup>512</sup> Information derived from the Web site of The Association of Lebanese Banks:  
<http://www.abl.org.lb/index2.html>

cent of the shares allow the investing foreign firm to have a say in the way the firm is operating. Apart from AGF, no other FDI attempts by EU firms in the finance sector were apparent.

## **6.5 Conclusion**

Judging by the criteria stipulated by the theories of foreign direct investment, the activities of EU firms in Lebanon appear to have involved very little direct investment in the post-civil war period. The case studies in this chapter and the categorisation provided in the previous chapter support this argument. EU firms followed one another in relatively large numbers into Lebanon with the beginning of the reconstruction process. This is normally the case with foreign firms; "they are like sheep, move in herds and flocks and follow each other once one leads the way".<sup>513</sup> In the case of Lebanon, they followed each other in bidding for contracts to rebuild the infrastructure of Lebanon. However, direct investment did not seem to have appealed to the crowds and lost ground to easy contracts. Apart from infrequent cases, EU private direct investments have been virtually non-existent. The niche in the Lebanese market for EU firms was laid in the contracts that were difficult for local firms to execute. Their experience gave them the advantage over local and Arab firms in many cases. In other cases, local and Arab firms had no chance to compete with EU firms, as the technological gap was too wide. Obviously, EU firms 'found the cheese' in contracting but certainly not in investing.

The cases of firms like Inchcape and France Telecom are not numerous. Those firms found the niche in the market to place a direct investment. For other firms, it is not quite the same. The Westernised mentality of the consumers encouraged Inchcape to introduce its Western style in retail. Other European firms had the same belief but did not risk their own capital (BHV/Monoprix). Instead, they franchised their business to a local investor. France Telecom and Finnish Telecom invested in mobile phone networks but had local partners. The presence of a local partner can be seen as a risk minimiser (in the case of Finnish Telecom the local partners owned the majority of shares). The local partner in fact knows the market and the investing environment much better than the new arrivals. The lack of the knowledge of the market is always a disadvantage for

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<sup>513</sup> Author's interview with Mr. Sinclair Road, COMET. Winter 1998.



foreign investors competing with local counterparts. By having local business partners, foreign companies rid themselves from obstacles resulted from their poor knowledge of the market. However, as far as the telecommunications sector is concerned, investment in the mobile phones network in Lebanon was commonly considered a 'gold mine'. Lebanon was in desperate need of telephone services and it was believed that the landlines network would take years to be rehabilitated and expanded. Even common people in Lebanon consider that the mobile phone companies operating in Lebanon made profits since the first day of operation. Indeed, these firms had collected in advance the price of phone-lines long before starting operation. A down payment of US\$ 500 was essential for booking a line in the then coming network. The investing companies benefited from the desperation of the Lebanese customers who were in real need of telephones. This proves that foreign businesses will jump on the chance for investment once the risk is minimal.

As for finance, the lack of FDI moves by finance firms raises two main points. Either the Lebanese market is not worth investing in because it does not offer attractive opportunities; or the market is already saturated with European finance firms that rejuvenated their businesses after the war. Certainly, the presence of European banks before 1993 cannot be underestimated. All were big names in international banking, particularly French. However, the reiterated governmental aim to regain Beirut's role as the financial centre would necessitate the flow of foreign finance firms into Beirut. The surge in the representative offices' numbers can be interpreted as a careful move to assess the available opportunities for business. These are issues to be explained more when we look at the reasons for the lack of FDI by EU firms in Lebanon. What can be emphasised here though, is that EU firms were attracted to Lebanon by opportunities arising from the massive reconstruction plan undertaken by the government. This European interest can be interpreted as a very short-term interest with very little commitment to the country.

## **Chapter Seven: Reasons for the Lack of FDI in Lebanon**

### **7.1 Introduction**

The theories of foreign direct investment have helped in defining the criteria by which FDI activities can be differentiated from other types of foreign businesses. In the previous chapter, I have used these theories to answer the 'What' question: What kind of foreign business can be considered foreign direct investment? Applying the answers to the case of foreign businesses in Lebanon, it was proved that very little direct investment has been included in the operation of EU firms in Lebanon. This also can be applied to other non-EU firms that operated in Lebanon in the same period (93-98). In this chapter, the same theories are used to answer the 'Why' question: why has there been very little FDI in the operations of foreign firms in Lebanon?

### **7.2 International Product Life Cycle Theory as a motive for FDI in Lebanon**

I shall start with the first motive stipulated by Vernon in his International Product Life Cycle Theory. To recapitulate, he considered FDI to be a subsequent step after international trade (i.e. production in the foreign market would replace exports). A new product would be developed in an industrialised country where the research and development facilities are available, in addition to the high consumer purchase ability. The same would later be exported to other countries within which competition would soon erupt from local producers imitating the new product. As locally manufactured products would normally have the advantage of not being subject to trade barriers, high custom duties or cost of transport, the exported product into such markets would face fierce competition. It is then that a decision to establish production abroad would take place, depending on the importance of the foreign market for the firm. This way a firm would avoid trade barriers, high custom duties, and costs of transport.

It is difficult to apply this theory to the case of EU firms in Lebanon. We have discussed earlier the case of the German firm, Siemens, and others like Ansaldo of Italy or Alcatel of France, and we found that they were in Lebanon only for contracting reasons and not investing. These companies are massive producers of electronic and

telecommunications equipment in addition to being contractors. However, their interest in Lebanon was confined to contracting. These firms have exported products to Lebanon, be they goods or technological expertise, produced either in their home countries or in other host countries. To investigate whether they have reached the stage where they should replace their exports to Lebanon by local production we need to answer a few questions: a) has there been any competition from local industry?; b) have trade barriers and custom duties been problematic?; c) has the cost of transport been affecting the competitiveness of their exports?

The exports of such companies to Lebanon cannot be faced by local competition because such production does not exist in Lebanon. Therefore, these companies would be competing amongst each other. This way, these companies are all equally subject to the same conditions like trade barriers and cost of transport and their competition is more affected by the cost of production in their country of origin. This is why we find that the size of Lebanon's imports from Italy, for instance, is the highest when compared to other EU countries, and even the US. The reason is that Italian products are cheaper on the Lebanese market than other products. These firms could possibly face competition from other producers in South Asia. However, local competition in this sense does not exist. Trade barriers in Lebanon are not a major problem. Lebanon is well known for the traditional freedom in importation. Some recent increases in custom duties on some products have caused concerns amongst traders. These increases, however, were intended to boost government revenues more than to curb imports. Nevertheless, products that are considered essential face fewer, lower custom duties. But, as mentioned earlier, all competitors would be facing the same rules.

These examples could be applied to plenty of other EU producers that export to Lebanon: Daimler-Benz (the producer of Mercedes cars) or Renault of France. Indeed, this applies as well to non-European firms: such as General Motors of the US or Hitachi of Japan. These firms, or others exporting to Lebanon, do not face local competition. Therefore, as far as the issue of reducing the cost of exports is concerned, such a motive does not apply to manufacturing firms exporting to Lebanon. Moreover, the analysis in the previous chapter has highlighted the Western orientation of the market. This mentality can serve EU producers in guaranteeing continuous marketing for their products in a 'Westernised' market like Lebanon. Therefore, it is not only the lack of

local competition, but also the guaranteed prestige of Western products in the market, that secure the market for EU exports.

### **7.3 Ownership of specific advantage as a motive for FDI in Lebanon**

A firm's specific advantage has been stipulated as a motive for FDI in many theories. In discussing the Monopolistic - Oligopolistic Advantage Theory, Toaka talked about an "exploitable factor" that the MNC should own to give it an advantage abroad.<sup>514</sup> Hymer, Kindleberger, Caves, and Dunning, all stressed the need for the firm to have a specific advantage to make any FDI activity successful. Kindleberger stressed that a firm in a foreign country must have an advantage over existing or potentially competitive firms, otherwise, local firms would be operating more cheaply.<sup>515</sup> Indeed, this factor of a firm's specific advantage is at the core of the Market Imperfection Theory, which Hymer was the first to discuss. He considered markets to be imperfect when there is a horizontal or bilateral monopoly or oligopoly, and suggested that collusion, by having all enterprises owned by one firm, would be profitable.<sup>516</sup> Markets of perfect competition where firms have homogeneous products and equal access to factors of production are rather theoretical, according to Caves.<sup>517</sup> His model of Market Imperfection stipulated the competitive advantages that firms acquire. Dunning's Eclectic Model stated that a firm should have almost the same advantages to conduct FDI: product differentiation; brand names; special marketing skills; and technology.<sup>518</sup>

Therefore, in the case of EU private direct investments in Lebanon, the following must apply: a firm's specific advantage is essential for any company before it decides to locate its business in Lebanon. By examining the case of Inchcape (Spinneys) through its retail business in Lebanon, we could detect a belief within that firm that it had a specific advantage to compete with local supermarkets. The firm believed that local supermarkets did not possess the same high standards as Inchcape.<sup>519</sup> Other direct investors like France Telecom and Finnish Telecom also had specific advantages that protected them from any local competition. They have entered a telecommunication

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<sup>514</sup> Taoka. G, op.cit, p.48.

<sup>515</sup> Kindleberger.C.P, op.cit, p.11.

<sup>516</sup> Hymer. S, op.cit, p.25.

<sup>517</sup> Caves. R, op.cit, p.17.

<sup>518</sup> Ibid.

Rugman. A, 1988.op.cit, p.119.

<sup>519</sup> Author's interview with Inchcape's general manager in Beirut. op.cit.

market that never had mobile phone services before. Therefore, local competition was not existent. However, their specific advantages would have been questionable had the market been opened to other telecom firms. These two firms and their local partners, thus, are largely protected from foreign competition by the government concessions.<sup>520</sup>

However, although foreign firms would have great specific advantages when compared to local firms, this does not mean that they should start producing overseas. We understand from the International Product Life Cycle Theory that FDI takes place when markets would be better served from within rather than through exports. Therefore, although the exporting firm might have great advantages as opposed to local competitors (like technology and brand names), that does not necessitate a move of production to the host country. The market might be still perfectly serviced and tapped through exports. This way, foreign firms would still be benefiting from market imperfection as well, if their exported products have proven to be very competitive and much in demand (i.e. market imperfection in trade). We have already established that the Lebanese market is accessible for exports and that local production does not represent strong competition to imported products.

#### **7.4 Internalisation as a motive for FDI activities by EU firms in Lebanon**

The process of producing a firm's product abroad can be established without a direct investment in the host country. Hence comes the authorisation and licensing rights given by the parent-firm to local producers in the foreign country. Franchise is one aspect of this method of production. The likes of Coca-Cola and McDonald's are very good examples of licensing and franchising. The product, be it a good or a service, is produced abroad by local firms that are supervised by the parent-firm just to maintain the quality and the reputation of the brand.

However, when the parent-firm decides that its knowledge of the product and the technology used are too precious to be transmitted to an outsider, a decision to extend its production arm to the foreign market becomes sensible. Robock argues that the firm's initial expenditure on research can be recouped if it keeps the use of information internal.<sup>521</sup> In explaining Dunning's view of internalisation, Rugman highlighted the

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<sup>520</sup> The two GSM firms have the exclusive right to provide mobile phone services in Lebanon.

<sup>521</sup> Robock, S, 1989. op.cit, p.45.

difficulty in valuing the technology being sold to the other firm. He also mentioned the advantages of using price discrimination and cross-subsidisation for products.<sup>522</sup>

In the case of EU firms in Lebanon, we have already established that market imperfection in itself did not tempt many EU firms to conduct FDI activities in Lebanon. Exports seemed to be the right way to tap the market as we already mentioned. Therefore, it is a bit difficult to find internalisation being on the agenda of EU firms interested in Lebanon when market imperfection has not yet tempted them. In the case of Inchcape (Spinneys), internalisation can be traced, as the team managing the venture was seconded from the parent-firm, and a direct control was being exercised by the parent-firm. However, in the case of BHV/Monoprix and other multinational firms like McDonald's or KFC, we could see that the firm had no objection to extending its knowledge to a franchisee.

In the case of France Telecom we can say that its operations in Lebanon are internalised. The parent-firm controls 67 per cent of the joint venture in Lebanon, and a managerial team from the parent-firm has been seconded. The same is the case of HSBC in Lebanon; a direct control from the parent-firm has been accompanied by internalisation within the firm and its arms in foreign markets.

However, the cases of EU firms that could be used as examples are very limited. This is due to the earlier conclusion that the market can be served by exports, whether in goods or in services. Manufacturers can export their products and would at most need a representative office to promote their products. Finance firms, as well, could export their services to the country and a representative office might suffice for them. Internalisation, therefore, is a late stage in the international production process, which foreign firms in Lebanon have not yet reached.

## **7.5 Oligopolistic reaction as a motive for FDI in Lebanon**

The essence of this approach is its explanation for a firm's decision to invest abroad following a rival firm's decision to establish production in the same foreign country. Knickerbocker said: "If a firm A makes a move, say investing abroad, then the concept of oligopolistic reaction tells us something about firm B, a rival to A, is likely to do".<sup>523</sup>

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<sup>522</sup> Rugman, A, 1988, op.cit, p.119.

<sup>523</sup> Knickerbocker, F, 1973.op.cit, p.8.

As we mentioned in the theoretical chapter, Knickerbocker built his model on the basis of Vernon's Product Cycle Model, which explained mainly the move of US firms towards producing abroad.<sup>524</sup> This was an explanation of how US firms followed each other in their overseas moves when American firms became skilled in 'pioneering' products while other foreign firms lagged behind.<sup>525</sup> Investment abroad involves uncertainty. This is what we referred to earlier while emphasising the need for a firm's specific advantage to compensate for the disadvantages of operating in a foreign market. Ietto-Gilles said that rival firms would also face uncertainty, however, it is more risky not to invest.<sup>526</sup> The risk here means leaving firm A to reap all the benefits of producing in the foreign market where competition is already weak. Knickbocker concluded that the behaviour of firms in oligopolies tends toward a pattern of action-reaction, and move-countermove.<sup>527</sup>

In the case of EU firms operating in Lebanon between 1993-98, it is a bit difficult to trace any oligopolistic reaction amongst FDI operations. One could argue that the period of time is rather short. In other words, the reconstruction period did not provide sufficient time for firm A to set up yielding operations to provoke firm B to set up similar operations. However, it is worth saying that when FDI is an oligopolistic reaction, it is normally a subsequent step to an aggressive move by the first firm that conducted FDI. In other words, the oligopolistic reaction is a defensive move. Nevertheless, the first move is still missing in Lebanon. In my view, oligopolistic reaction in FDI will be easier to trace if and when there is a significant trend of FDI activities. In the case of Lebanon, we have already established that FDI, particularly by EU firms, is still minimal.

However, we can detect some early moves of investment that may be considered as oligopolistic reaction. Referring back to the case of Inchcape (Spinneys) and MonoPrix, we could see that the latter followed the former. It is possible to suspect that the move by the owner of MonoPrix franchise in Lebanon is an oligopolistic reaction to Inchcape's move to open Spinneys. However, the investment came from a local investor who brought the French brand into the country, not from the French chain itself. Moreover, the argument that the local investor has been motivated by the opportunities

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<sup>524</sup> Ietto-Gillies. G, 1992.op.cit, p.130.

<sup>525</sup> Ibid.

<sup>526</sup> Ibid.

rising from a Westernised market proves to be stronger, and thus the move is still aggressive. After all, MonoPrix did not establish business in Lebanon to protect an existent market share from the aggressive move of Inchcape.

The moves by many EU finance firms to establish offices in Lebanon could also be considered as an early oligopolistic reaction. It is the “bandwagon effect” that Ietto-Gilles talked about when trying to explain the defensive moves of foreign investment.<sup>528</sup> This might explain how most of these firms registered their representative offices within a short period. However, these moves were not really FDI activities, as we already concluded in the previous chapters.

## **7.6 Location-specific advantage as a motive for EU firms FDI in Lebanon**

The Eclectic Model, or the O.L.I. Model developed by Dunning, has shed light on the importance of the location in motivating a firm to conduct an FDI activity. This crucial point has not been noticed by preceding theories of FDI, which focused on other factors. Only the Product Life Cycle Model touched upon this point when it mentioned trade barriers as a motive for firms to establish production in foreign countries. However, this theory did not take the factor of location any further. McDermott considered that Dunning’s location-specific advantage means there are certain benefits to be gained by exploiting the firm-specific advantages outside the home country.<sup>529</sup> Dunning acknowledged that a firm serving a market through foreign production depends on resource endowments not available to, or not utilised by other firms. These endowments could be ownership specific (i.e. internal within the enterprise) or location specific (i.e. available to other firms and should be used in their locality).<sup>530</sup> He drew a long list of location specific “variables” that would affect direct investment activities whether in the home or the host countries. Amongst these variables were the access to natural resources and markets; availability of production factors at a competitive price; cost of transport; investment incentives and disincentives; and artificial barriers (i.e. trade barriers).<sup>531</sup>

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<sup>527</sup> Knickerbocker, F, 1973. op.cit, p.5.

<sup>528</sup> Ietto-Gilles, G, 1992. op.cit, p.130.

<sup>529</sup> McDermott, M, 1989.op.cit, p.10.

<sup>530</sup> Dunning, J.H, *International Production and the Multinational Enterprise*. (London: Allen & Unwin, 1981) p.25.

<sup>531</sup> Dunning, J.H, *The Globalisation of Business. The Challenge of the 1990s*. (London: Routledge, 1993) p.99.



This contribution by Dunning to the theory of FDI is of great help in this research: it explains the lack of FDI activities in Lebanon. Rugman suggested that they could also include skilled low-cost labour force. Other important factors are the size of the market, the cost of factors of production, the level of bureaucracy in government administration, corruption, and above all political stability. Government policy in providing pull-factors, such as financial incentives, should also be counted as location-specific advantage. These are the factors that were highlighted by the interviewees chosen for this research. In discussing these factors, they showed Lebanon's position as far as attracting FDI is concerned.

### **7.6.1 Trade barriers**

In the earlier discussion on the motives of FDI according to the Product Life Cycle Theory, we established that trade barriers in Lebanon are not substantial. Apart from a few agricultural products that compete with local produce, almost all 'legal' goods can be exported to Lebanon. Custom duties have been increased in the last few years but this cannot be considered part of a protectionist policy as much as it was to boost government revenues. One major reason for the increase in the value of custom duties is the adjusting of the exchange rate of these duties. During the 1980s, the sharp devaluation of the Lebanese currency was not extended to affect custom duties. Instead, the rate of the LL against the US Dollar remained strong. This way, revenues from custom duties were negligible. High custom duties were imposed on car imports, particularly used cars. The motive was to reduce the number of old cars in Lebanon for ecological reasons. Yet, custom duties in general were still within affordable limits. In this sense, trade barriers were never a serious problem for exports into the Lebanese market and thus foreign producers did not have to improvise another way to jump trade barriers. If the producer was concerned about the Lebanese market solely, then the lack of trade barriers can be interpreted as a reason for the lack of locating foreign production in Lebanon.

## **7.6.2 Natural resources**

These are the factors of production provided by nature.<sup>532</sup> It refers to all the freely given material phenomena of nature within the boundaries of men's activities. Additional qualities of situation and location can be considered natural resources. These include fertile land, oil, coal or other ores or mineral deposits, natural forests, rivers which can produce hydroelectric power, wind if it can be usefully harnessed as a source of power, rainfall etc.<sup>533</sup> Examples of FDI activities motivated by natural resources can be drawn from around the world. Kvaerner's pulp and paper industry is located in countries like Brazil<sup>534</sup>, amongst others with abundance in forests. Over 30 per cent of Totalfina's output of oil comes from the Middle East region.<sup>535</sup> The activities of these multinational firms in these particular countries were obviously attracted by the natural resources available there.

Natural resources are hardly existent in Lebanon. The small size of the territory does not provide enough fertile land for agricultural investments. Urbanisation has reached remote areas due to the need for housing. This affected forestation as well.<sup>536</sup> Similarly, there have been no records of oil discovery in Lebanon so far, while coal and other minerals are not available. Big multinational oil firms have interests in countries endowed with substantial amounts of oil resources. Lebanon does not fall within this category.

## **7.6.3 Size of the market**

The size of the market is one of the major factors that would affect the firm's decision to invest or not. The market in this case means the size of demand demonstrated by local consumers of the firm's product, or even the potential for adequate demand that would allow the firm to recoup its investment. This could be demonstrated through a large population with a strong or sufficient purchasing power. A high GDP per capita would contribute to the host countries' comparative advantages.

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<sup>532</sup> This is how the Oxford Dictionary for Economics defined it.

<sup>533</sup> Pearce. D. W, *The MacMillan Dictionary of Modern Economics*. (1981) p.302.

<sup>534</sup> Kvaerner's web page: <http://www.kvaerner.com/pulp/>

<sup>535</sup> Totalfina's web page: <http://www.totalfina.com/us/profil/activite.html>

<sup>536</sup> Ironically, investment in the timber industry could have been more feasible thousands years ago, during the Phoenician time. The mountains of Lebanon were then covered with forests.

In the case of Lebanon, the country's GDP per capita, which is over US\$ 4,000, is the highest in the region (excluding oil-producing Gulf countries and Israel). The purchasing power parity and growth in private consumption are the highest as well. The imports of Lebanon are also relatively the highest (according to population size).<sup>537</sup> However, with a population of only 4 million, Lebanon does not provide substantial opportunities for manufacturing industries. Shehadi pointed out that Lebanon's position as a host country for FDI depends on the sort of industry considered. He noted that if the product is a high value-added one, then it is the purchase ability that determines the size of the market. As far as low value-added products are concerned, the size of the population becomes equivalent to the size of the market. "I think Lebanon has no chance in this field (...) the market is small and our neighbours have closed economies."<sup>538</sup> The Israeli market is absolutely out of consideration due to the Arab boycott policy towards Israel. Meanwhile, the Syrian market is one of the most difficult markets to penetrate due to the governmental control of importation. The government of Harriri has concluded trade agreements with Syria in which trade between the two countries was to be facilitated by abolishing trade barriers. However, the fruits of this development have yet to be seen. Along these lines, it could be argued that a firm that is engaged in producing low-price clothes would be better placing its investment in a country like Egypt instead of Lebanon. Egypt, with a population of 60 million would certainly provide a better market than Lebanon. However, would Lebanon be a better market for stereo systems or computers? These are high-tech products with high value-added. It has to be said that although Lebanon's GDP per capita and its purchase power per capita are higher than Egypt, these figures do not show the real differences in income levels and wealth distribution within each country. Therefore, even if we assume that 50 per cent of Lebanon's population has the ability to buy a PC, this would leave us with 2 million people. Meanwhile, if we assume that 5 per cent of Egypt's population could afford buying a PC this means 3 million buyers. In this sense, Egypt would appear a more attractive market.

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<sup>537</sup> See tables provided in the previous chapter. The section on Inchcape.

#### **7.6.4 Cost of factors of production**

These are the economy's productive resources that are essential for any production process. They are classified as: land, labour, capital and entrepreneurial ability. In this part, the first three factors are to be discussed. As for the fourth factor, entrepreneurial ability, it is to be disregarded as this thesis is concerned with exogenous entrepreneurs who do not form part of the productive factors that Lebanon offers.

##### **7.6.4.1 Cost of land and property**

The cost of land and property can be crucial in encouraging or discouraging a foreign firm wanting to establish FDI activities. This is in fact a major problem for investments in Lebanon. The limited size of the territory and the centralisation of business activities in the capital Beirut increased demand for property in the region. Thus, the cost of land and property in Beirut and the surroundings is very expensive.<sup>539</sup> Hamdan considered real estate to be the major component of the asset of any factory. This, he argued, puts Lebanon in a less competitive position in the region. In the Gulf countries, real estate is the minimum component of any factory's assets, as it would be given to the investing firm by the government for 99 years.<sup>540</sup> While the cost of property in the regions is relatively cheaper than in the capital's surroundings, this would mean facing the expensive costs of transport. Shehadi commented that the cost of transporting a lorry-container load from Mount Lebanon to the port of Beirut is equal to shipping it to Marseilles in France. Therefore, the cost of acquiring property to establish a factory could be a real obstacle discouraging FDI.

##### **7.6.4.2 Availability of skilled-cheap labour**

Labour is also one of the major factors of production whose availability is crucial in determining the location of production. If a company decides to establish production in a foreign market to increase its competitiveness within the market, it implies a move towards reducing the cost of the product. A more expensive labour force than in the home country would not encourage an FDI move. Whether the company is looking for

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<sup>538</sup> Author's interview with Dr Kamal Shehadi, Lebanese economist.

<sup>539</sup> Author's interview with Dr Antoine Haddad, Lebanese economist. op.cit.

<sup>540</sup> Author's interview with Dr Kamal Hamdan, Lebanese economist. op.cit.

unskilled-cheap labour or skilled-cheap labour depends on the needs of its line of business. Nevertheless, firms involved in manufacturing would tend to look for skilled or semi-skilled labour.

In Lebanon, skilled labour is not available at a competitive cost. All interviewees for this research, whether Lebanese economists or European business representatives, agreed that the labour factor is not competitive in Lebanon. Opinions ranged from negating the presence of skilled labour in Lebanon,<sup>541</sup> to its scarcity in industry, mainly intensive labour industries.<sup>542</sup> When available, it does not fit the EU requirements, particularly at the medium-size managers' level,<sup>543</sup> and when technical skills, manufacturing industry and tourism services are concerned.<sup>544</sup> Nevertheless, the majority agreed that, when available, skilled labour is expensive and hardly competitive when compared to its counterpart in neighbouring countries.

The lack of competitive labour is the result of various factors. Some are inherent in Lebanon's economic development since independence, and others are the result of more recent changes. In the manufacturing industry, the lack of competitive skilled labour can be attributed to the fact that Lebanon is not an industrial country. At the best of times, Lebanon's industry contributed 20 per cent of the country's GDP. During the post-independence period, the country was developing an economy dependent mainly on financial and non-financial services. At a time when neighbouring countries, like Syria and Egypt, were pursuing a process of industrialisation to substitute their dependence on imports (ISI), Lebanon was applying an entirely different strategy. The Lebanese financiers found in the plight of Arab private businesses, being nationalised, a niche for their business prosperity. Lebanese banks became the shelters for flight capital from these countries. These events widened the pace of development in the financial services sector. Meanwhile, development in industry was at a much slower pace. Moreover, unlike other neighbouring countries, the governments of Lebanon never provided substantial subsidies to local industries. In other words, industrial development depended fully on the capacity of private entrepreneurs. This gave Lebanese industry

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<sup>541</sup> Author's Interview with Lebanese economist Antoine Haddad. op.cit.

<sup>542</sup> Author's interviews with Lebanese economists Dr Elie Yashoui and Mazen Hanna. Beirut July 1998.

<sup>543</sup> Author's interview with the representative of the Delegate for German Trade and Industry, Alexi Nassan. Beirut. July 1998.

<sup>544</sup> Author's interview with Lebanese economist Dr Kamal Shehadi. op.cit.

the characteristic of being primarily composed of family businesses, with many operating with less than 10 employees. Such a situation does not contribute to developing a large pool of skilled labour from which a foreign company could pick its labour force. Meanwhile, the nationalisation of industry in countries like Syria and Egypt got the state directly involved in industrial development. Factories grew bigger while vast numbers of employees were recruited by the state to operate them. This factor gives countries like Egypt a comparative advantage when FDI is concerned. The abundance of labour contributes to reducing its price on the pure basis of supply and demand. Meanwhile, the lack of skilled labour in Lebanon, and the flight of many of them during the war, widens the gap between their high cost and the low cost of their counterparts in neighbouring countries.

In the services sector, the situation is a little better. The country developed a very successful services sector in the 1950s and 1960s. The Lebanese banking sector was serving not only Lebanon but also the whole region as far as the Gulf countries. Trade also developed immensely and the port of Beirut became the principal Levant port after Haifa was relegated to a mere Israeli port and the Suez Canal became inaccessible. This development in the sector needed a parallel development in the labour force. Indeed, an impressive skilled labour force was built in Lebanon's financial and non-financial services sector. This ranged from financial services, including banking and insurance, to non-financial services including tourism, health-care and education. The economic prosperity between the post-independence and civil war periods had its spill over effect on the standard of living of people involved in prosperous sectors. Their personal incomes were higher than those of their counterparts in neighbouring countries. However, their counterparts, say in Egypt or Syria, were not operating in the same domain. The state-led economies in these countries imposed a rigid system on financial and non-financial services in which labour skills did have neither incentives, nor means to develop.

The civil war destroyed almost all competitive advantages of Lebanon in the services' field. Finance and commercial activities had to move to other regional centres. Some of these new centres were in fact just opening up, like Cairo. Moreover, the Gulf region developed its financial services. The civil war culminated in the flight of the majority of skilled labour in the financial sector to Europe or to the Gulf. The civil war also caused

a slow pace in the development of financial and non-financial services at a time when competing regional centres were developing rapidly. The labour force that has stayed in Lebanon appeared to be behind, by the end of the war. Their counterparts in the Gulf, for instance, have developed up-to-date skills and were much more familiar with the new technology used in the sector.

In addition to the high cost of property in Lebanon, industries, in particular, face another high cost in the utilities needed for running a factory. The major expensive utility is electricity.<sup>545</sup> Any visitor to Lebanon will easily notice the complaints about the high cost of electricity. The cost of kwh in Lebanon is higher than anywhere else in the region. It could be argued that the higher cost is a result of huge thefts taking place on the network. However, the government does not provide any subsidised electricity to industries. When compared with Gulf countries or Syria, the cost of electricity in Lebanon is extremely uncompetitive.

#### **7.6.4.3 Cost of finance**

A major incentive for foreign direct investments could be cheap finance. Many firms tend to finance their projects through debt and/or equity instead of investing their own capital. In Lebanon it is almost impossible to get a bank loan for building or upgrading a factory. Most bank loans are short term and go into financing trade. For example, the loans given by Lebanon's biggest bank, BLOM, in 1998 included only 12 per cent for manufacturing. Meanwhile, trade activities received 48 per cent. The general manager of the investment arm of BLOM argued that manufacturers expect long-term lending at lower interest rates. He added, "why should I, as a bank, lend at a lower interest rate when I could lend at a higher one?"<sup>546</sup> Indeed, the higher rate that Osseiran referred to was not only offered by the commercial sector but also by the government. To finance its reconstruction programme and current expenditure the government was offering high interest rates on treasury bills. Osseiran wondered how he could lend a manufacturer at 7 per cent interest rate when the government was offering 18 per cent. As previously explained, the government was crowding out the private sector by offering high interests that hardly any business could achieve.

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<sup>545</sup> Author's interview with Alexis Nassan. op.cit.

<sup>546</sup> Author's interview with Dr Fadi Osseiran. General manager of Banque D'Affaires Du Liban et D'Outre-Mer SAL. (BALOM). August 1998. Beirut.

This high cost of finance would discourage foreign investors as well. It is also contributing to lowering the comparative advantages of Lebanon against other countries in the region. Hamdan argued that the cost of finance in the Gulf is cheaper as interest rates are around 7 per cent.

Therefore, when it comes to considering the cost of the factors of production, Lebanon appears to have no comparative advantages at all. Labour, land and capital are comparatively expensive. Even if we assume that some factors, like capital, could be arranged from other sources, the cost of other factors of production is still influential.

### **7.6.5 Public administration**

The problems with government or public administration can range from a high level of bureaucracy to the lack of transparency, and the absence of either a clear policy on foreign investments or an appropriate legal framework.

#### **7.6.5.1 High level of bureaucracy**

The term bureaucracy was first used in 1745 by Vincent de Gournay as a derogatory reference to a type of government in which power resided with officials. He was then describing the Prussian government.<sup>547</sup> Max Weber (1864-1920) developed bureaucracy, however, as an “ideal type” of social system. He considered bureaucracy to be typified by a rational and effective organisation that operates on the basis of 1) rules by which tasks are organised; 2) a division of labour which produces specialisation; 3) hierarchy, meaning superior-subordinate relationships; 4) decisions by technical and legal standards; 5) administration based on filing systems and institutional memory; and 6) administration as a vocation.<sup>548</sup> Bureaucracy in the contemporary world “refers primarily to government agencies that are characterised by day-to-day policy implementation, routine, complex procedures, specialisation of duties, rights of authority and status, and resistance to change”.<sup>549</sup> Chandler noted that bureaucratic behaviour is often objectionable to citizens because it denotes delay, red tape, pettiness, ritualistic attachment to rules, and concentration of power in persons neither elected by

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<sup>547</sup> Chandler, R.C, *The Public Administration Dictionary*. 2nd edition. (Santa Barbara, Calif : ABC-Clio, 1988) p.168.

<sup>548</sup> Ibid. p.169.

<sup>549</sup> Ibid.



nor responsible directly to the people.<sup>550</sup> However, he pointed out that the pathological aspects of bureaucracy do not necessarily refer to bureaucracy as a social organisation but largely to the pattern of individual behaviour of bureaucrats.<sup>551</sup> No wonder then that a bureaucrat is defined in contemporary dictionaries as an “inflexible administrator”.<sup>552</sup>

In Lebanon, the level of bureaucracy is perceived to be high, although it does not have the reputation of being massive and Soviet-type as in other neighbouring countries.<sup>553</sup> Yet, this does not deny the hindering effect on foreign businesses. The war has contributed markedly to the deterioration in the public administration and subsequently to the bureaucratic problems.<sup>554</sup> Shehadi commented that many of the documents and licences needed for business are meaningless. “These made a lot of sense in the 1940s but do not make sense at all now-a-days”.<sup>555</sup> Indeed, it is common that a document in a public-administration department would have to pass through many offices and accumulate a huge number of signatures. Many parts of such process sound incredibly backward these days. Hanna referred to these procedures as small red tape steps that hinder FDI in Lebanon.<sup>556</sup>

The accumulation of red tape in Lebanon’s public administration is the source of major complaints from the business community in Lebanon, whether local or foreign. Lebanon in fact is not unique in this sense. Complaints of red tape in public administration existed almost everywhere in different levels. Kaufman pointed that when people rail against red tape, they mean that “they are subjected to too many constraints, that many of these constraints seem pointless, and that agencies seem to take forever to act”.<sup>557</sup> Chandler stated that red tape originated in seventeenth-century England, where it was the practice to tie official documents with a tape of reddish hue. He added that “procedures, rules, and regulations – often referred to as red tape- *protect* people’s rights as well as cause them annoyance”.<sup>558</sup> Therefore, “excessive rule making is frequently the outgrowth of good intentions on the part of the legislators to prevent,

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<sup>550</sup> Chandler. R.C, *The Public Administration Dictionary*, op.cit, p.169.

<sup>551</sup> Ibid.

<sup>552</sup> Isaacs. A, *The Oxford Dictionary for the Business World*. (Oxford University Press: 1993) p.105.

<sup>553</sup> Author’s interview with Jim Sillar, Assistant to the Secretary-general of The Arab-British Chamber of Commerce. London. May 1998.

<sup>554</sup> Interview with Mazen Hanna, Advisor at the Ministry of Finance. op.cit.

<sup>555</sup> Interview with Dr Kamal Shehadi. op.cit

<sup>556</sup> Interview with Mazen Hanna. op.cit.

<sup>557</sup> Kaufman. H, *Red Tape: Its Origins, Uses, and Abuses*. (Washington: Brookings Institution, 1977) p.4.

<sup>558</sup> Chandler. R.C, 1988.op.cit, p.233.

correct, or eliminate abuses within the system". However, "when excessive red tape causes the system to be virtually inoperative, the red tape must be cut".<sup>559</sup> Lebanon's problem is in fact the excessive red tape that causes huge delays in getting targets achieved. It is not only due to excessive use, as Chandler suggested, but also because the rules are out of date. The 'bureaucrats' of Lebanon are using rules that were established decades ago and have not been updated since.

The red tape in the Lebanese administration has resulted in a more dangerous problem, which is bribery. Obviously, more strict rules that involve a lot of bureaucratic work would result in the need to deal with numerous numbers of public administration departments and tens of clerks. It has become common knowledge that any stamp or signature has a price. Moreover, to avoid going through such a vicious circle, the job of a mediator has become prosperous. They offer their services to go around collecting 'signatures' for an agreed price. This is the bribery and hidden-tax that businesses suffer from in Lebanon. It became a system in itself, and anyone who does not know the system faces big difficulties in, for example, opening a shop in Lebanon.<sup>560</sup> The advisor to the minister of Economy and Trade highlighted that a lot of hidden-taxes are paid in the government administration.<sup>561</sup> In our case studies we noted that Spinneys faced the hidden-tax problem in very petty ways. In Kvaerner's case, its project manager rejected the name hidden-tax because it is well known to happen "in this part of the world". However, he said that it causes problems but does not hinder the business.<sup>562</sup> However, Shehadi argued that bribery is creating an extra cost for business, and reaches in some estimates 3 to 5 per cent of a company's turnover. An investor would not have any interest in setting up a business in such a case, as this could be half or more than the company's profit, he added.<sup>563</sup> As Hamdan put it: "they say we have reduced taxes on profits but this [bribery] is another tax, and a great obstacle for FDI".<sup>564</sup>

<sup>559</sup> Chandler. R.C, 1988.op.cit, p.234.

<sup>560</sup> Author's interview with Mazen Hanna. Ministry of Finance. op.cit.

<sup>561</sup> Author's interview with Dr Helmi Ghandour. Advisor to the Minister of Economy and Trade. Beirut. July 1998.

<sup>562</sup> Author's interview with Ken Gilder. Kvaerner's project manager in Beirut. op.cit.

<sup>563</sup> Author's interview with Dr Kamal Shehadi. op.cit.

<sup>564</sup> Author's interview with Dr Kamal Hamdan. op.cit.

### 7.6.5.2 Lack of transparency and openness

To be transparent is shortly defined as being obvious and easily understood.<sup>565</sup> While discussing transparency in the European Union, Janet Mather suggested that it should have three dimensions: First, the *minimal transparency* that includes availability of comprehensible information. "Any system which lacked this could hardly be termed transparent at all". Second, the *liberal transparency* by which access to the thinking behind decisions is guaranteed. "If we know how decisions have been made and who contributed to them, we can hold decision-makers accountable in the last resort", she said. Third, the *democratic transparency* by the opening of decision-making process to non-governmental participation. "If a polity is to be considered democratic, there should be sufficient information available to enable people to participate in decision-taking".<sup>566</sup>

In Lebanon, even minimal transparency does not exist in the public administration. Hamdan considered the lack of transparency to be "the big obstacle" in the way of attracting FDI.<sup>567</sup> It is almost impossible to acquire information about business regulations or even on a particular company. This is one of the major problems that this research faced while collecting data. Relevant statistics were not easily obtainable. For foreign businesses such a situation is certainly discouraging. Not knowing the way around leads to falling into the traps of delay and bribery. Being secretive about rules and information helps only the bureaucrats in maintaining their control. That is how every little clerk in a governmental department becomes substantially important as he could easily keep someone's documents in his drawer as long as he wants. Nassan noted that to get a work permit or a residency permit for a foreigner, a bribe is essential. He wondered why he should pay over US\$ 1,500 to get his secretary a work and residency permit while it would cost only US\$ 100 in Saudi Arabia. He called this problem a hidden investment barrier.<sup>568</sup> This makes other Arab countries much cheaper as a base for operations, indeed. Obviously, foreign businesses in most cases are not willing to go through such hideous procedures.

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Also, Author's interview with Philip Khoury, strategy analyst at Flemings. London. June 1998.

<sup>565</sup> *The Oxford Dictionary for the Business World*. (1993).op.cit. p.880.

<sup>566</sup> Mather, J, *Transparency in the European Union – An Open and Shut Case?* In *Openness and Transparency: Meaningful and Meaningless?* Conference papers. European Information Association 1997. p.3.

<sup>567</sup> Author's interview with Dr Kamal Hamdan. op.cit.

<sup>568</sup> Author's interview with Alexi Nassan. op.cit.

### **7.6.5.3 Lack of a legal framework for FDI**

The legal framework that is meant here is a list of laws and rules that should include the rights and duties of foreign companies or persons interested in investing in Lebanon. However, it should be made clear that the regulations are not negative towards foreign investments. On the contrary, the Lebanese governments have always been proud of the freedom of business activities granted by the legislator without differentiating between a native and foreign firm. Ghandour proudly declared that Lebanon was a pioneer in the region where rights for establishment are concerned.<sup>569</sup> It is true that Lebanon gave foreign businesses the right to operate freely when neighbouring countries were nationalising all foreign interests. The Lebanese rhetoric was emphasising that what applies to Lebanese applies to foreigners. This is true to a great extent. The freedom to transfer capital in and out of the country, to open bank accounts in any currency, the free exchange market, and bank secrecy, all were beneficial to local and foreign businesses. However, the problem is embodied in the lack of a legal framework that combines all the laws applying to foreign businesses. The laws that govern foreign businesses operations in Lebanon are scattered between rules concerning registration, the form of the company, taxation, rights of employees, and others. These rules are not separated from the ones related to local businesses. The excuse for such a situation was that Lebanon never distinguished between foreign businesses and local ones. Business guides tend to talk about the open and liberal business environment when the regulatory framework is discussed. They refer to foreign businesses only when certain exceptions apply.<sup>570</sup> However, a foreign businessman would not have the time to go through all commercial laws to find what would apply to his firm's case in Lebanon. In other neighbouring countries certain laws have been introduced to encourage foreign investment. In Syria the Law 10 of 1990 sums up all the rights and duties of foreign businesses in Syria. It could be argued that Syria needed the Law 10 because foreign investment was not allowed before. This is absolutely right, but Lebanon needs a similar regulation to facilitate the matter for foreign investments.

Moreover, despite all claims that the Lebanese legal framework is welcoming to foreign investments, there remains a certain discrimination against foreign businesses. This comes under the exceptions that are scattered amongst commercial laws.

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<sup>569</sup> Author's interview with Dr Helmi Ghandour. *op.cit.*

Firstly, foreigners have a very restricted right to ownership of property and real estate. According to the Legislative Decree No. 113 dated 16 September 1983, non-Lebanese are not permitted, except as provided for in the law, to acquire any real estate rights in Lebanon. "Said rights include real estate property, rent of land and built real estate if the duration of such rents exceeds ten years, investing real estate property...etc."<sup>571</sup> The Decree states that:

*No permit may be granted:*

- 1) Regarding real estate located within ten kilometres from the Lebanese boundaries.*
- 2) To one person for an area exceeding 3000 square meters in all Lebanon including a maximum of 1000 sq. meters in Beirut...*

*Nationals of Arab countries may acquire an area not exceeding 5000 sq. meters in all Lebanon including a maximum of 2000 sq. meters in Beirut.*<sup>572</sup>

The Decree goes further in its restriction, stipulating that the acquisition of bigger areas can be permitted but in very limited cases. This includes companies involved in the construction of buildings for sale, industrial or tourist companies. However, these companies should have at least half of the shareholders with Lebanese nationality. Effectively, this means that the company is almost local. Moreover, the area required should not exceed 20,000 sq. meters (a maximum of 5,000 in Beirut). For scientific, cultural, charitable institution or diplomatic and consular missions, such permits could be granted as well. The necessity of the acquisition for the project is essential and the maximum area authorised would not exceed 3,000 sq. meters in Beirut and 10,000 sq. meters outside Beirut for diplomatic missions. For scientific and charitable institutions the size goes up to 15,000 sq. meters.<sup>573</sup>

The 'dilemma' of the foreign person or company does not stop at the very limited right to ownership. The process of applying is another problematic procedure that is enough to put off any investor from continuing. The Decree stipulates that the application to acquire real estate should be submitted to the department of real estate at the Ministry of

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<sup>570</sup> Emerging Lebanon 2000. The Annual Business, Economic, and Political Review, op.cit, p.157.

<sup>571</sup> Nasr. K, Business Laws and Taxation in Lebanon (1996) p. 62.

<sup>572</sup> Ibid.

<sup>573</sup> Ibid.

Finance. This should include in addition to essential personal information, a statement from all concerned real estate departments in the country showing all real estates owned by him in Lebanon; a declaration made and signed before the Notary Public stating all properties owned by the applicant. In case of corporations, the application would need further paper work. Eventually, a decree issued by the Council of Ministers within three months would guarantee the licence, if the application were to be approved. If rejected, the application may not be submitted again before two years are up. Moreover, taxes on registering a property for a non-Lebanese are rated at 17 per cent of the value of the property itself.<sup>574</sup>

Secondly, in establishing a Joint Stock Company (equivalent to Public Limited Company in the UK), there are no laws limiting the nationality of shareholders. However, the majority of the board of directors have got to be of Lebanese nationality. The head of the board of directors can be a foreigner as long as a work permit has been granted.<sup>575</sup> Nevertheless, if this newly established Joint Stock Company is to be involved in "the exploitation of public utilities" it should have one third of its capital represented by registered shares owned by Lebanese shareholders. These shares may not be transferred to non-Lebanese in any case.<sup>576</sup>

Thirdly, in a Limited Liability Company, all partners can be foreigners. However, if the firm's objective is to engage in commercial representation it should have a Lebanese partner.<sup>577</sup> Moreover, an LLC does not have the right to engage in businesses like insurance, economy, savings, regular air transport, banking and capital investment for the account of third parties. This, however, applies to local and foreign firms operating in Lebanon.<sup>578</sup>

Fourthly, a Holding Company should have at least two members of the board of directors of the Lebanese nationality.<sup>579</sup>

Fifthly, concerning foreign insurance companies, in addition to not being allowed to operate in Lebanon unless they are set up in the form of a joint stock company, the

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<sup>574</sup> Nasr. K, (1996), op.cit.

<sup>575</sup> Stephan. J. S. "Lubnan a-na'iem a-dareebi: al-isstissmarat fi Lubnan" (Lebanon the Tax Haven: Investments in Lebanon) (Beirut: 1997) p. 16.

<sup>576</sup> Nasr. K, (1996).op.cit, p.35.

<sup>577</sup> Emerging Lebanon 2000. op.cit, p.159.

<sup>578</sup> Nasr. K, (1996). op.cit, p.32.

employees of such companies should be Lebanese except for three foreign specialists and one manager or general representative.<sup>580</sup>

Sixthly, foreigners are not allowed to conduct any commercial representation business. The Legislative Decree No. 34 of August 1967 defined a commercial representative as "the agent who within the framework of his normal independent profession, and without being bound by an employment agreement, undertakes negotiations for the conclusion of sale, purchase, hire and services, and should the occasion arise, carries on such activity in the name of producers or merchants and for their account".<sup>581</sup> The modifying Decree No.9639 of February 1975 stated that the commercial representative should be a Lebanese national having a place of business in Lebanon. In partnerships and limited liability companies, the majority of partners should be Lebanese and the majority of capital is to be owned by Lebanese partners. The person authorised to sign for such firms is to be Lebanese as well. In a joint stock company, the shares and the majority of its capital should be owned by Lebanese shareholders, as well as two-thirds of the members of the board of directors. The general manager or his delegate should all be Lebanese.<sup>582</sup>

On top of all these regulations, the registration procedure for a branch of a foreign company is not a straightforward procedure. After preparing a long list of documents, these should be attested by the authorities concerned in the home country of the company and legalised by the Lebanese consular official there. These documents should then be authenticated by the Lebanese Ministry of the Exterior in Beirut. A sworn translator should then translate them into Arabic before they can be legalised by the Notary Public. These documents should then be submitted with an application for the approval of the Ministry of Commerce and Economy. Once such approval is granted, a copy of the documents should be submitted to the Commercial Register with an application containing a summary of the Articles. This application should be in duplicate and should contain a long list of information about the firm, the location of its head office and worldwide branches, names of partners, amount of capital, and others.<sup>583</sup> Moreover, the commercial registration charge for any company or

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<sup>579</sup> Nasr. K, (1996). *op.cit*, p.32 & Stephan. J, *op.cit*. p.20.

<sup>580</sup> Nasr. K, (1996). *op.cit*. p.50.

<sup>581</sup> *Ibid*. p.18.

<sup>582</sup> *Ibid*. p.19.

<sup>583</sup> *Ibid*. p. 52.

establishment is LL 1,200,000 (US\$ 800). In addition, a stamp duty of LL 1,800,000 (US\$ 1,200) is levied upon the formation of a foreign joint stock company. This figure is reduced to LL 1,000,000 (US\$ 666) if the joint stock company is Lebanese. A factory, and industrial or commercial establishment would pay LL 750,000 (US\$ 500). Add to that, a 0.1 per cent of the company's capital to be paid to the Notary Public Office for the Lawyers Syndicate. Likewise, to register in the Chamber of Commerce and Industry, there is an initial fee ranging from LL 146,000 (US\$ 97) to LL 582,000 (US\$ 388) depending on the capital of the firm, in addition to a stamp duty of LL 25,000 (US\$ 16)<sup>584</sup>. Such a procedure would certainly be a nightmare for a foreigner who does not know the country and its administration. Indeed, it is a hideous process for locals. It would certainly discourage any investor who is a bit dubious about the FDI move.

#### **7.6.5.4 Labour social security cost**

The social security for labour is ruled by Decree No. 13955 that goes back to September 1963, which stipulates the regulations for the National Social Security Fund. There have been huge complaints from the business community in Lebanon about the backwardness of these rules, which force employers to endure huge costs.<sup>585</sup> Clearly, the current regime is disputed not as an obstacle for FDI only but also as a serious problem for local businesses. It has been claimed that it contributes strongly to the high cost of labour in Lebanon.<sup>586</sup>

The Social Security in Lebanon is divided into three sections: sickness and maternity insurance; family allowances scheme; and end of service indemnity scheme. The rules stipulate that these sections are funded by employers, employees and the Lebanese government.<sup>587</sup> However, the stipulated contribution of employees and employers shows that the employer has to meet almost the whole cost. The following figures explain how the share is divided.

- Sickness and maternity (Health insurance): 15 per cent of the employee's salary.  
This amount should not exceed three times the minimum monthly salary limit

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<sup>584</sup> Ibid. p.17.

<sup>585</sup> Author's interview with Sa'ad El-'Owayni, General manager of the Lebanese Industrialists' Association. Beirut. August 1998.

<sup>586</sup> Ibid.



decided by the government (LL 300,000). However, 12 per cent is to be paid by the employer while the employee pays the remained 3 per cent.

- Family allowances scheme: It is equal to 15 per cent of the employee's salary. This also should not exceed the value of three times the minimum monthly salary. However, the employer pays it totally.
- End of service indemnity scheme: This represents an equivalent of 8.5 per cent of the monthly salary. The employer pays the whole amount.<sup>588</sup>

Effectively, the payments to the Social Security Fund amount to an equivalent of 38.5 per cent of the monthly salary. However, only 3 per cent of the salary is to be paid by the employee while the employer pays the rest (35.5 per cent). Therefore, a foreign company that is interested in operating in Lebanon should take into consideration that taxation is only a maximum of 10 per cent on corporate income as the taxation law states. There is the extra cost of social security that the company would have to endure.

#### **7.6.5.5 Work and residency permits for foreigners**

Any foreigner needs a work permit, to be obtained from the Ministry of Labour and Social Affairs, before undertaking any job in Lebanon. This includes employees and employers. Theoretically this work permit could be granted, as long as there is no prejudice to the policy that a Lebanese national is given priority and preferential right. However, the Ministry of Labour and Social Affairs has a long list of jobs and professions exclusively reserved for Lebanese nationals. According to the Ministerial Order dated 11/1/1993, foreigners may not be given work permit as employees in all administrative and banking jobs of any kind, mainly manager, deputy manager, head of personnel, treasurer, accountant. Also secretary, filing, computer, storekeepers, salesman, exchange, jewellery, laboratory, pharmacy, electrical and sanitary works, glass, mechanic and maintenance, office boy, guard, teaching in elementary, intermediate and secondary schools with the exception of teaching foreign languages when necessary, engineering works, barber, driver, and jobs where Lebanese are available.<sup>589</sup>

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<sup>587</sup> Stephan. J 1997. op.cit. p.117.

<sup>588</sup> Ibid.

<sup>589</sup> Nasr. K. 1996 op.cit. p.59.

Concerning foreign employers, not all professions are opened to them. The same Ministerial Order points out some professions that are exclusive for Lebanese. These include all kinds of trading, exchange, accounting, commercial representation, commission, engineering of all kinds, contracting and building trade, jewellery, shoes and clothes industry, all kinds of furniture and other complementary industries, sweets, printing, publishing and distribution, manufacturing building materials, barbershops, cars maintenance, and in general any profession that may form competition to the Lebanese.<sup>590</sup> Once the profession allows a foreigner to be an employer, he/she would need to be in a partnership with one or more Lebanese nationals. Nevertheless, the Lebanese share in the capital should be over 51 per cent, and the contribution of the foreigner no less than LL 500 million (around US\$ 333,330,000). The Residency Permit could be obtained once a work permit has been granted.

However, the cost of the permits for work and residency are significantly high. The work permit charges go up from LL 150,000 (US\$ 100) for the lowest category to LL 1,000,000 (US\$ 666) for the highest category. These are preceded by prior approval charges ranging from LL 30,000 (US\$ 20) to LL 200,000 (US\$ 133). Charges for the residency permit range from LL 200,000 (US\$ 133) to LL 800,000 (US\$ 533). These charges are the same upon renewal, which should take place in a maximum period of two years.<sup>591</sup> To calculate the administrative cost for foreigners to set up a business in Lebanon we realise that a foreign investor whose interested in establishing business in Lebanon and being the employer, the preliminary cost would be around US\$ 2,418. The foreign party should be operating within a partnership and, as mentioned earlier, his/her capital should be no less than LL 500 m and his/her share would represent no more than 49 per cent of the total capital. For a foreign company without a registered foreign employer, with one foreign employee at least, it would be around US\$ 2,284. Both cases are comparatively expensive.

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<sup>590</sup> Nasr. K. 1996 op.cit, p.59.

<sup>591</sup> Ibid. p.61.

**Table 7.1 Administrative cost facing foreign companies in Lebanon**

Administrative cost for a local firm with a foreign employer	Administrative cost for a foreign firm with no foreign employer
Registration charge as a local firm                      LL 1,000,000	Reg. Charge as a Foreign company                      LL 1,800,000
Work permit (employer)      LL 1,000,000	Work permit                      LL 600,000
Reg. Chamber of Commerce                      LL 327,000	Reg. Chamber of Commerce                      LL 327,000
Lawyers Syndicate fee	Lawyers Syn fee                      LL 100,000
0.1 % of total capital      LL 500,000(min) <sup>a</sup>	(min)
Residency permit <u>LL 800,000</u>	Residency permit <u>LL 600,000</u>
Total cost :                      LL 3,627,000  US\$ 2418	Total cost:                      LL 3,427,000  US\$ 2284

*a- The minimum cost of the Lawyers Syndicate fee is LL 100,000, but a foreign employer is required to have a minimum capital of LL 500 m which takes the fee up to a minimum of LL 500,000, before counting the cost to be encountered by the local partner.*

These costs are to be met before doing any business in Lebanon, and the delay in going through the whole procedure can be imagined. Part of this ill-favoured procedure must be repeated every time permits are to be renewed. Extra costs are incurred once any foreign employee has joined the firm's labour force in Lebanon.

These requirements and costs appear backward when compared to the process of establishing business in a developed country. In the UK, for instance, there is no charge for getting a work permit for foreigners. The recent revision of work permit arrangements stated that no decision has been made to charge for it. Moreover, it considered a scheme to allow multi-national employers to self-certify rather than apply for a work permit for employees on intra company transfers, which will be piloted to

assess whether there are benefits to be gained.<sup>592</sup> To facilitate the process of applying for work permits, which is the employer's duty, a new facility to apply by e-mail was being introduced.<sup>593</sup> For investors, a sum of £ 200,000 (around US\$ 320,000) marked for investment in the UK is enough to grant the applicant a one-year visa. If the business is set up within that period an extension of three years can be granted. Permanent visa can be given after the four-year period has elapsed and if the business subsists.<sup>594</sup> There are no restrictions on property ownership for foreigners. Obviously, there is a wide gap between investment environments in countries like the UK and Lebanon.

#### **7.6.5.6 Lack of a coherent policy to attract foreign investments**

Apart from the problems created by the heavily bureaucratic administration and the outdated legal framework, the development of FDI activities in Lebanon faces the lack of a coherent strategy to attract foreign direct investments. The Lebanese government established the Investment Development Authority of Lebanon (IDAL) in 1994, to attract foreign investment. Its task was to identify large-scale investment opportunities and facilitate their implementation.<sup>595</sup> In fact, IDAL's job was preparing studies for projects that can be developed in B.O.T., D.B.O.T., or O.T and tendering documents for the said projects. However, IDAL has not been very successful in attracting foreign direct investments into the tendered projects. The response was limited to a few car-park projects, and other O.T projects. The big projects that IDAL focused on, like industrial zones and the Beirut-Damascus toll-road, failed miserably. The failure of IDAL's proposed free-industrial zones to be built on a B.O.T. basis in the North and Bekaa were attributed to the wrong policy followed by IDAL. Yashoui commented that foreign investors would not be interested in building free-industrial zones, as IDAL proposed. He pointed out that the answer of foreign investors was that the government should build these industrial complexes and then foreign industries would use them as operation bases.<sup>596</sup> Hayek, from IDAL, refuted this argument asserting that IDAL has conducted many studies about the need for industrial zones. These studies were supported by an American consultancy firm, and a potential for these industrial zones

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<sup>592</sup> Overseas Labour Service (DFEE): "[Work Permit Review](http://www.dfec.gov.uk/ols/)" Release RB.2.3 Mar 2000.  
<http://www.dfec.gov.uk/ols/>

<sup>593</sup> Ibid.

<sup>594</sup> [Business Emigration to the United Kingdom](http://www.awis.net/uk-biz.html). <http://www.awis.net/uk-biz.html>

<sup>595</sup> IDAL Web page: <http://www.idal.com.lb/about/about.htm>

<sup>596</sup> Author's interview with Dr Elie Yashoui, Lebanese economist. op.cit.

was found. Hayek was very optimistic that a positive response to the proposed industrial zone B.O.T. projects was immanent.<sup>597</sup> However, up till the time of writing these words, this response had not materialised.

In addition to the creation of IDAL, the Lebanese government decided, under Hariri, to slash corporate and personal income taxation to a maximum of 10 per cent. Moreover, they emphasised the principles of the free market system praising the freedom of exchange, freedom to transfer capital in any currency and banking secrecy. The government also embarked on a massive reconstruction project to rebuild the devastated infrastructure of the country. In fact, the government did a very satisfactory job in rehabilitating the infrastructure of the country. One of the government's major aims was to build this infrastructure to attract private investments, including FDI. However, a question arises here: are sophisticated infrastructures and hanging projects enough to attract foreign investors? A British businessman's reflection on the situation was that creating a perfect climate for foreign business could be achieved anywhere; however, the technique for bringing investors into that climate is more important.<sup>598</sup> He asserted that a process of worldwide advertising should take place after identifying the target investors. Nevertheless, this should be within a strategy by which the government would first identify the strengths in its economy and the sectors that could attract investors. Sillars criticised the policies of Arab governments, including Lebanon's, when it comes to attracting foreign investments. "I do not get the impression that Arab governments have done sufficient analysis of what their economies can do, their limitations in terms of attracting investors into their domestic economies, and their potential in attracting investors to locate in an Arab country to serve a wider market" he stated.<sup>599</sup> A native Scot, Sillars was proud to present the case of Scotland as an example of a coherent policy to attract foreign investments. With a small population of 5 million, Scotland had no chance in attracting a car manufacturer to invest in the country, he asserted. The cost of transporting the bulky products to the main market in England and Europe would be high. Instead, the Scots targeted electronic companies that produce computers. Scotland already had an associated industry with them through the

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<sup>597</sup> Author's interview with Kamal Hayek. Engineer and Financial Analyst at IDAL. Beirut July 1998. (Now he is the head of IDAL).

<sup>598</sup> Author's interview with Sir Jim Sillars, Assistant to the Secretary-General of the Arab-British Chamber of Commerce. London. May 1998.

<sup>599</sup> Ibid.

microchip industry. These companies serve the UK and European markets from Scotland.

Sillars emphasised the need to look for the strengths of the economy and the niche for investment before targeting foreign investors randomly. In a way, the struggle between countries to attract FDI is like trading in a market. Every seller would have to display his goods nicely to attract the sight of the buyers. The best vendor would be the one who does not rely on the display only but shouts to attract a bigger crowd for his best items. Lebanon's problem is that the government and the business community have not defined the best 'items' to display clearly and advertise. Instead, they were advertising the items that every 'seller' has got, and most probably in a better shape and at a better price. In reality, the Lebanese government did not identify the strengths of the economy and in which sectors Lebanon would have comparative advantage. Instead, the Lebanese government always praised the infrastructure the country has rebuilt, in addition to its free market, and free banking sector. However, almost every country trying to attract foreign investment provides equivalent, if not better, infrastructure, and they give a package of financial incentives. Nevertheless, the most successful amongst these countries are the ones that highlight their comparative advantages. They attract investors by the lucrative packages they offer, which would include feasibility studies that can reassure them. Lebanon's packages did not include any significant financial incentive apart from the traditional freedom to exchange currency and remit profit, in addition to low-rates of taxation. Tax exemptions were available only for projects in the proposed industrial zones. Moreover, the Lebanese government did not provide any financial guarantees for foreign investors. This was the major reason for the failure of the toll-road project, as the Lebanese government refused to promise to top-up the revenues of the investing companies if the turnover fell short of covering the cost of investment. The Lebanese government made it clear that in B.O.T. projects, the entrepreneur should bear the financial risk entirely. The obvious reason for the lack of such financial incentives is the inability of the government to provide financial guarantees. The Lebanese government favoured the B.O.T. schemes to rid itself of the financial burden of constructing these projects.

### **7.6.6 Lack of political stability**

To all the above inherent obstacles for foreign direct investment, we should add the prevailing problems resulting from the lack of political and economic stability in Lebanon. This thesis cannot refute the negative impact of instability in the country. However, this thesis would disagree with the argument that achieving comprehensive peace would cause a flow of FDI.

Although the civil war has ended since 1991, Lebanon has still not yet achieved political stability. The country is not 100 per cent safe for investments, mainly when the investor is a foreigner who would have very limited knowledge of Lebanon. The fact that part of the country was, during the researched period, still occupied by Israel contributes highly to the lack of a sense of security for foreigners in Lebanon. Certain Lebanese opposition factions also interpret the presence of Syrian troops in the country as another occupation. During the period between 1993-98, the reconstruction process was at a peak, yet foreign investments proved to be far below expectations. Obviously, the lack of stability and security maximises the risk for businesses. The peace process between Lebanon and Israel gave hope to the Lebanese government, the business community, and some foreign businesses. Nassan stated that the German Trade Delegate opened its office in Beirut in 1995 because of the peace process.<sup>600</sup> However, the stalemate in the negotiations proved the widespread optimism to be wrong. Moreover, the subsequent escalations in tensions in southern Lebanon, which mounted, from time to another, reaching Beirut and the northern parts of the country, could have easily caused a setback to any developing business interest in the country. The ex-PM Hariri, whose government embarked on the massive reconstruction plan, was blamed for betting too much on the imminent accomplishment of peace between Lebanon and Israel.<sup>601</sup> Corm also criticised the government of Hariri for having built its policies on the hope that peace was coming soon.<sup>602</sup> The hope for the imminent achievement of peace seemed to recede further with the election of Benjamin Netanyahu as Prime Minister in Israel in 1996.<sup>603</sup> However, despite all the accusations that Hariri's policies

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<sup>600</sup> Author's interview with Alexis Nassan. op.cit.

<sup>601</sup> Barazi, M., "Al-Hariri wal-furass a-da'iaa: qiraah fi 'aahd wa-'auhoud". (*Hariri and the Lost Opportunities*). (Beirut, Data and Investment Consult – Lebanon: 1999) p.9.

<sup>602</sup> Corm, G, 1996. p.85. (George Corm became the Minister of Finance in the Salim Hoss cabinet that succeeded Hariri's.

<sup>603</sup> *Emerging Lebanon 2000*. op.cit, p. 12.

were reliant on the 'coming' peace, Hariri declared after his departure from the government that he never considered peace to be unequivocally happening. "It is paramount to emphasis that, while we have always viewed peace as an objective, we never gambled on it" he said.<sup>604</sup>

Another aspect of political instability in the country is the presence of Syrian troops in almost two-thirds of the country. Although the Lebanese government reminds the opposition regularly that the Syrian troops have entered Lebanon upon the Lebanese government's request, part of the opposition still consider the Syrian military presence as occupation. For a foreign investor, this situation would be precarious, with worries that a military conflict would erupt. Nevertheless, it does not take an expert to detect the Syrian influence in Lebanese internal and foreign politics. Since the signing of the Taif Accord and the consequent defeat of General Michel Aoun, Syria has been playing a stabilising role in Lebanon. Its contribution to the dismantling of militias is undeniable. Yet, the overwhelming dependency on the Syrians to stabilise the country and decide on foreign policies could be seen as a destabilising factor by foreign businesses. The strong influence might prove very unhealthy in case of any crucial changes within Syria.<sup>605</sup>

Nevertheless, although the civil war has ended years ago, the period between 1993-99 did not show a clear reduction in sectarianism. True, parliamentary elections have been restored and three rounds of elections have already taken place. However, a commonly agreeable electoral law had yet not been reached by the end of 2000. Every round of the three elections was to be preceded by lengthy debates on the form of suffrage law for the expected elections. The main concern before every elections round was the representation of communal leaders, and how to divide constituencies in the best way to serve their interests. In other words, the basic principles of the Taif Accord concerning abolishing sectarianism in the government are yet to be implemented in the electoral system, let alone the administration. This division of the society and the intensified pre-elections disputes could be seen as a real threat for stability in the country, and thus increase the risk for foreign investments.

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<sup>604</sup> Hariri, R, *Statesmanship in Government. Emerging from War and Entering the Future*. (Beirut, Arab United Press Co: 1999) p.91.



### **7.6.7 Lack of economic stability**

The situation of the Lebanese economy during the reconstruction period was discussed in details in the third chapter. These details have shown the dramatic developments that took place after the arrival of Hariri into the PM's office reflected in a short spurt of economic growth followed by a downturn trend. Therefore, the macroeconomic picture of Lebanon's economy was not very encouraging in the second half of 1990s. The 8 per cent growth of GDP in 1994 declined to 6.5 per cent and 4 per cent in 1995 and 1996 respectively,<sup>606</sup> while the planned growth rate had been anticipated at 9 per cent over a 10-year period. Inflation was controlled at 10 per cent but dollarisation was over 56 per cent of deposits. Public finances contributed to the bleak image, with around 52 per cent in budget deficit/expenditure in 1996. This deficit was rated at 18 per cent of GDP in the same year.<sup>607</sup> Public debt reached over US\$ 16.50 bn (Nominal domestic debt + foreign debt) in 1997. This situation was reflected in the verdicts of the rating agencies, which saw a BB minus for long term credits by Moody's due to the high risk resulting from high public debt and budget deficit.

The lack of economic stability affects the flow of foreign direct investment in several ways. Any company with outward-investment intentions would be scared off by a declining growth rate in the economy of the host country. This would create fears of not recouping the firm's investment. The failure of the government's fiscal policies to reduce the budget deficit would not impress foreign direct investors. The steady growth in public debt reaching dangerous limits certainly increases the risk element for any investor. The currency might not be able to resist and so plunge to very low rates, taking with it any investments conducted in the Lebanese Pound. The low tax rates policy is surely an incentive, yet it is useless when other incentives are not available.

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<sup>605</sup> Author's interview with Andrew Gilmour. Head of Middle East and North African Department. The Economist. London. May 1998.

<sup>606</sup> Oxford Business Group. *Lebanon: The Annual Business, Economic and Political Review 1997-8*. op.cit, p.37.

<sup>607</sup> Ibid.

## **7.7 Conclusion**

The Lebanese governments under Hariri between 1993-98 have proved to be a failure in attracting foreign direct investment. It can be claimed that the first years of reconstruction were aimed at rebuilding infrastructure to establish a welcoming environment for FDI. However, three years after commencing the reconstruction process, significant FDI was yet to come. Statistics showed that FDI was very shy. It is true that a good infrastructure is essential for attracting foreign businesses, however, other factors are crucial for any direct investment activity. The criteria to attract FDI were not fulfilled in Lebanon. Certainly, the governments of Hariri should not be blamed solely for the lack of FDI. The flaws were related to a combination of factors that involved the nature of the country, the size of the market and the cost of the factors of production. Lebanon is not endowed with natural resources that would attract foreign companies. Lebanon is one of the very few Middle Eastern countries that were not fortunate enough to discover any oil reserves in their territories. This did not only prevent activities in oil extraction but also raised the cost of energy for manufacturing industries. The size of the market did not offer any potential for volume production in manufacturing to allow investing firms to benefit from economies of scale. The Hariri governments worked on some trade agreements with Arab countries to guarantee access for Lebanese products. But the agreements with Syria are yet to yield positive results. As long as the Syrian consumer purchasing power is low, opportunities to benefit from the Syrian market will anyway be very limited. Moreover, in case of a dramatic development in the Syrian economy by which a great degree of openness would be granted, there would be no guarantees of FDI inflows into Lebanon's manufacturing industry. Syria itself might stand as a far better destination for the foreign investment. This is due to the fact that factors of production are far cheaper than Lebanon. The factors of production - land, labour, and capital, are not available at a competitive price in Lebanon. Land and property are amongst the most expensive in the region while cheap-skilled labour is a rare commodity. Interest rates on borrowed capital cannot be higher.

On the other hand, the government's policy exacerbated the ill-favoured situation of FDI environment. The legal framework was not adequately improved to create a transparency. Instead, red tape kept riddling administrative procedures and thus

corruption flourished. The case studies of this research have shown that corruption and bribery did exist in the Lebanese administration. This situation was either to be accepted to do the business, like in the case of Kvarnaer, or to be fought against and lose to, as in the case of Ecomax. On top of these disincentives, political stability was yet to be achieved during Hariri's era, a development that he was accused of betting on unrealistically. Meanwhile, economic stability was growing far from being reached. These last two factors contributed largely to the high risk facing the establishment of any foreign business in the country. It is no wonder afterwards if FDI activities were not very popular in the Hariri period, not only amongst EU firms but foreign businesses in general.

After applying the theories of FDI to the case of EU firms in Lebanon, it can be suggested that the lack of the location-advantage is the most important reason in explaining the lack of FDI activities in Lebanon. The absence of significant intentions to exploit firm-specific advantages or to internalise firm's activities was related to the poor comparative advantages that the location provided. The moves to utilise a firm-specific advantage or to internalise activities are, therefore, measures to exploit a location-specific advantage. In Lebanon, the factors that could strengthen its location-advantages were absent. This thesis argued that a combination of these factors accounted for the lack of FDI in Lebanon. However, the limited size of the market and the high cost of factors of production were, and still are, the most decisive factors. Political instability should not, nevertheless, be ignored. All these factors proved that Lebanon was not competitive in attracting FDI.

The obstacles hindering FDI in Lebanon affect equally all foreign businesses whether they were EU firms or non-EU foreign firms. The size of the market, for instance, affects any producer considering setting up some production in Lebanon. The same applies to the cost of factors of production and the lack of natural resources. This explains why the lack of FDI activities was not confined to EU firms but also reflected the situation of firms from other foreign countries. The major foreign investments came from Arab businessmen who directed their capital into some touristic projects, particularly hotels, and some banking activities. This in fact follows the historical pattern of Arab investments in Lebanon. Arab capital was always channeled into such projects. Yet, it has to be said that the Arab interests in investing in Lebanon's tourism

are no match for their interests in neighbouring countries like Egypt. Again, Lebanon's comparative advantages were weakened during the period of civil war while the others have moved on.

## Conclusion

The purpose of this thesis was to examine the extent and nature of European (EU) business activity in Lebanon, and in particular to analyse the extent of EU private FDI within that activity during the period of reconstruction (1993-98). The thesis established that the Lebanese government under Hariri was eager to attract such investment as part of the private sector's contribution to the reconstruction programme. The private sector was expected to respond to the state-led reconstruction process by parallel investments to instigate growth in the economy. The local private sector failed to meet the government's expectations, partly due to the crowding-out effect of the government's intensive borrowing from the domestic sources to cover its doubling budget deficits. The thesis demonstrated that although EU firms have substantially increased their activities in Lebanon, they also have not been engaged predominantly in FDI activities.

Using the criteria drawn from the theoretical material on FDI, this thesis explained that the lack of FDI activities amongst EU firms was due to the lack of comparative location-specific advantage in Lebanon. This advantage was highlighted in Dunning's Eclectic Model of FDI as a motive for establishing production in a particular foreign country. Other theories that stressed the role of *firm-specific* and *internalisation* advantages fell short of explaining, on their own, the reasons behind the lack of EU private direct investments in Lebanon. A firm could move its production into a certain foreign country to exploit a specific advantage related to its products (*firm-specific advantage*). This advantage can be due to higher quality, or popularity of the brand. A firm could also decide to internalise its operations in a particular foreign country to keep the result of its R&D internal (*internalisation advantage*). However, the decision to operate in that particular foreign country would have reasons related to advantages stemming from the locality. It appears that Lebanon lacked many comparative *location-advantages* that EU firms could have benefited from.

A significant increase in EU firms' activities in Lebanon was instigated by the reconstruction process. Many EU firms moved into Lebanon bidding for reconstruction contracts. EU firms received the majority of the contracts tendered by the government to rehabilitate the infrastructure of the country. These firms were more qualified to do the

arising jobs that needed giant firms with extensive experience. Local and Arab firms were not qualified to be in charge of massive projects, like the rehabilitation of the electricity or telecommunication sectors. US firms, on the other hand, did not represent competition due to the US ban on its citizens travelling to Lebanon. Yet, it has been noted that the EU and member states have improved the positions of EU firms in bidding for tendered projects, by providing conditional finance. France has been particularly forward in this regard. The close historical relationship between France and Lebanon has given French businesses an edge in their comparative cultural and linguistic knowledge of Lebanon. It is not surprising therefore to see that French firms represented the majority amongst EU firms operating in Lebanon, and those awarded contracts.

I have shown that Lebanon proved to be a good place for activities related to trade and contracting during the reconstruction period. However, it did not develop into an attractive destination for FDI activities. In the following paragraphs I shall endeavour to suggest what should have been done to improve the competitiveness of Lebanon's location-advantages to attract FDI from the EU and other sources of foreign capital.

The most important point is that the situation requires a strong government intervention to formulate a proper strategy to tackle the problems resulting from the lack of comparative *location-advantages*. These are the ones related to the limited size of the market, high cost of factors of production, absence of coherent legal framework for FDI, and political and economic instability.

- Size of the market: Any firm interested in producing in Lebanon is faced with the limited size of the market. Despite a comparatively high per capita GDP, the limited size of the population affects the size of the market. The local market, although high consuming, offers limited opportunities for giant European producers. Moreover, the market is very competitive, and in certain industries or trades, a new arrival would have to be very careful in conducting competition. This was obvious in the case of the French supermarkets' chain – Ecomax. Local competition forced the European operator to retreat after sustaining heavy losses. It was suggested also that the giant ice-cream producer, Walls, decided to drop plans to establish production in Lebanon. The

feasibility studies showed that around 5 local producers controlled the local market.<sup>608</sup> Walls apparently realised that it would face fierce competition while the market is not worth such risk. Instead, Walls decided to establish its production in Egypt where location-advantages were more competitive: less local competition in a massive market.

The Lebanese government needs to expand prospects for the marketing of locally produced goods in order to attract investments into manufacturing and other industries. For such purposes, the establishment of a regional free-trade area would be beneficial to Lebanon. The Syrian market is the obvious destination to aim to expand into. Lebanon and Syria have signed a free-trade agreement in February 1998 stipulating a gradual elimination of custom duties between the two countries. This agreement was a part of the co-operation process that started between the two countries with the 1991 Brotherhood, Co-operation and Co-ordination Treaty. However, these agreements are faced with a mixed feeling in both countries. In Lebanon, it is believed that the free-trade agreements allow for an unlimited inflow of low-cost Syrian products into the Lebanese market. Although it is beneficial for consumers, the Lebanese domestic industries would suffer competition. Meanwhile, some industrialists in Syria believe that the Lebanese market was already an accessible free market, and thus Lebanese producers would be benefiting from having access to the traditionally closed Syrian market.<sup>609</sup> It is true that Syrian industrial products have flooded the Lebanese market. Factors of production in Syria are much cheaper than Lebanon. Meanwhile, Lebanese exports are facing a low purchasing power consumer in the Syrian markets. It is beyond the focus of this thesis to assess the pros and cons of economic agreements between Lebanon and Syria. However, the agreements between the two countries should be seen positively, particularly in terms of attracting FDI into the two countries.

A viable argument would be that a foreign investor would prefer to establish business in Syria itself rather than serving the market from Lebanon. This could build on the fact that factors of production are cheaper, and the population is quadruple that of Lebanon. However, Lebanon's industry still has some comparative advantages that its Syrian counterpart lacks. Although Syrian industry has received the support of the regime, particularly when the bulk of it was public sector, it still lacked the competitive quality.

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<sup>608</sup> Author's interview with Paul Khawaja, Commercial Attaché at the British Embassy- Beirut. July 1998.

Being protected by trade barriers guarantees domestic industries the needed market without having to worry about foreign competition. Meanwhile, Lebanese industry was more in touch with developments in technology. Therefore, in certain industries, Lebanese labour is more qualified to operate modern machinery than his Syrian counterpart. The latter, thus, would need more training. Consequently, the quality of Lebanese products is higher than similar Syrian products.<sup>610</sup> Moreover, the concentration of industries is not identical in the two countries. Food-processing industries represents 25 per cent of total Lebanese industry while manufacturing and textile industries represent 14 and 13 per cent respectively. Syrian industry, on the other hand, is concentrated in textiles, which represent 46 per cent of total industries. Manufacturing industries represent 25 per cent, while food-processing industries represent 15 per cent.<sup>611</sup> Co-operation rather than competition is, hence, the best way to serve the interests of the two countries to attract FDI into their industrial sectors. The Lebanese industrial sector should work to become the gateway to Syrian industry.

Historically, Lebanon was always ahead of Syria in its relations with the international market, while Syrian industry has got cheaper factors of production. The first step towards attracting FDI into industry should be the establishment of Lebanese-Syrian joint ventures that would benefit from the advantages in both countries. Lebanese food industries, for instance, can benefit from Syrian cheap labour and cheaper agricultural products. Syrian textile industry, on the other hand, can benefit from the Lebanese expertise in producing a higher quality. Successful joint ventures would be able to attract foreign producers who would be keen to utilise the comparative advantages of producing in Lebanon or Syria, for both local and foreign markets. Lebanese firms, in this sense, could convince potential foreign investors to rely on them for dealing with production and marketing in Syria and Lebanon. The Lebanese are more qualified than the Syrians in doing so due to their history in dealing with the western world and foreign companies.

The enlargement of the market to attract FDI cannot be limited to Syria and other Arab countries. This would certainly be helpful if foreign investors are interested in serving

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<sup>609</sup> DailyStar, Lebanese daily. Damascus players have mixed reviews for free trade agreement. 6-7-1998.

<sup>610</sup> Al Hayat, Arab daily. 22-4-1999. p: 19.

<sup>611</sup> Ibid.



the markets of the region. However, the Lebanese should be aiming at FDI in local production for foreign markets, like the EU. To succeed in attracting investments from EU private firms for such purposes, Lebanon should first acquire access to the markets of the EU. The only available way, currently, is through signing a Euro-Mediterranean partnership agreement with the EU. The access to the EU markets would incite European producers to invest in Lebanon if the cost of production was cheaper than in Europe and other Mediterranean countries. Moreover, it would attract investments from countries whose exports do not receive a similar treatment by the EU. In this sense, many firms from South Asian countries might be interested in setting up production in Lebanon. The products of these firms would enter the EU as Lebanese exports. Therefore, reaching a partnership agreement with the EU would help in attracting FDI activities from the EU or other countries interested in free access for its exports to the EU markets.

- Cost of factors of production: The above 'best scenario' assumptions would need other motives for FDI to be available. Access to an enlarged market is obviously appealing for foreign producers. Yet, this needs to be accompanied by other motives. Most important is the availability of factors of production at a competitive cost. Otherwise, foreign producers will stick to serving the Lebanese market, and the potentially enlarged market, through exports. We have already established that factors of production in Lebanon are not competitive. First amongst these factors is labour. The cost of skilled labour - once available- is not competitive compared to other investment destinations. There is, however, an abundance of unskilled cheap labour coming mainly from Syria. This pool of émigré labour has been useful for EU firms involved in construction projects. It can be used in industries where high skills are not required, or be trained to do certain jobs. Inevitably, the Lebanese government should embark on a serious plan to develop vocational training centres that cater for the needs of the international market. Therefore, a good deal of attention should be given to computer-related and high-tech industries. The availability of a pool of trained labour gives investing firms the choice to pick qualified labour. Moreover, the government should create financial incentives for potential investors to get involved in training labour. The government, for instance, could give tax concessions in return for training provided by investing firms. This method would be more efficient indeed, because the investor would qualify the employees according to the business' needs and save the government spending on

training in some unattractive sectors. The issue of the cost of labour is problematic partly because it is related to the relatively high cost of living in Lebanon, and partly because of the high cost of social security endured by the employer. The employer's contribution to social security, which amounts to an equivalent of 32 per cent of the salary, should be amended. The solution to the problem of social security in Lebanon does not necessarily mean passing the system to private hands, which in turn might charge more competitive rates. Indeed, the private sector is generally believed to fail in delivering the services included in the social security or do so in "a sub-optimum and inefficient way".<sup>612</sup> Therefore, the social security should remain within the public sector, but redistribute the contributions in a more business-encouraging way. It is well known that the salaries of the majority of Lebanese labour force are quite low compared to the cost of living. This implies that any increase in the 3 per cent contribution met by the employee might lead to social disturbance. The government, therefore, should increase its contribution to the social security. This can be done through maximising revenues from direct taxation. This would be more equitable as it would spread the cost amongst high-income earners and spare the low-income earners extra costs. This way the burden would not be carried by employers only but also by high-income earners. However, such move is in need of an overall rehabilitation of the taxation system in Lebanon, which is a huge fiasco. The other reason for the high cost of labour, the high cost of living in Lebanon, might be more difficult to overcome. However, the cost of living in the regions is much lower than the cost in Beirut and the surroundings. The establishment of industrial plants in areas of the Bekaa Valley, southern and northern Lebanon would reduce the cost of labour immensely. To achieve this, the government would have to work seriously on attracting businesses into these regions. The Hariri governments presented the plans for free-industrial zones in the North and the Bekaa. However, these projects were tendered to the private sector on B.O.T. bases. These projects, which included the provisions of airports, did not attract private investments. The Lebanese government should instead have a more comprehensive and feasible plans for these industrial zones. It might be more conducive if the government led the programme by building parts of the premises and leasing it to private investors, or lease plots of land in these zones to private developers. Moreover, the government should develop some affordable housing for the labour force, which might be tempted by work

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<sup>612</sup> Hockley, G.C, *Fiscal Policy: An Introduction*. (1992, Routledge - London and New York). p: 136.

opportunities to migrate from the city. These areas should be also connected with a very reliable transport network so that people living in these areas would not feel isolated. Such move might be considered a gamble, as foreign investment might not respond. This has to be combined with a set of measures that would form an appealing package for foreign investment. In any case, Lebanese private investments would be interested in establishing production in such areas once necessary provisions are provided.

The second factor of production that is an obstacle for attracting FDI into Lebanon is land. The cost of property is astronomical and not remotely competitive. This is also related to the concentration of businesses in the capital Beirut and its surroundings. Against this dilemma, the Lebanese government should look seriously into developing the above-mentioned zones for investments in industry. The government should provide land for industrial development through leasing at very competitive rates. Again, it is necessary to emphasise the role of the government in such a process. Private businesses would not be interested in developing the said zones into industrial estates. The whole tendered B.O.T. projects might not be feasible and include high risk. Any private investor cannot guarantee a positive response from industrialists to the proposed zones. Moreover, even if industrialists were interested in operating in such areas, the turnover might not be satisfactory for the private developer. Therefore, the proposed solution here is to reiterate the importance of the government's role in being in charge of these free industrial zones. The government could put a master plan and lease land to private developers at a very competitive price. Eventually, the government should not be so much seeking huge profits from this process, as it should be aiming at the positive impact of industrial production in these areas. These potential businesses would create thousands of employment opportunities that are desperately needed in those areas, and would certainly improve Lebanon's balance of foreign trade by maximising exports. One problem that industries might face in locating in areas like the interior Bekaa Valley or northern Lebanon is transportation. The cost of transportation is already expensive in Lebanon and locating far from the main cities would create problems for reaching the markets and extra costs. It has to be said here that the government's plan to provide attached airports to the proposed industrial zones in the Riyak (Bekaa) and Quleaat (North) is not very effective in this sense. The cost of transporting by air is the most expensive amongst any other options. Therefore, the emphasis should be made for proper overland transportation to reach internal and neighbouring Arab markets, and

access to ports for exports to overseas and imported raw materials. The road network has been developed immensely since the beginning of the reconstruction period. Apart from the congested Beirut-Damascus highway, all other vital roads have been improved. However, the Lebanese should reconsider their attitude towards railways, which have been out of service for decades. The Lebanese government has agreed to consider reviving a commuting train service on the coastal line but seems to be adamant on the issue of revitalising the Lebanese section of the old Beirut-Damascus line. It has been considered economically unfeasible. However, such attitude adopted by the Lebanese government is very short sighted. The benefit of railways would be more apparent in freight-transport sector as imports and exports could be carried straight from the port of Beirut to the proposed industrial zones in the Bekaa area. The Lebanese government should look at all the benefits that can be achieved through a railway network. It would first solve the problem of congestion on the mountainous road to Damascus by reducing the number of lorries engaged in transit trade from the port of Beirut. Thus, the government can abandon all expensive projects for finding alternative routes. Railways would also increase the mobility of labour and thus reduce the demographic pressure on Beirut. That is apart from the fact that it is less polluting. More importantly, it would reduce the cost of transport, particularly if it were to be linked to a proper regional network through which exports to other Arab countries can be transported easily. Unfortunately, the emphasis on railway construction has been historically minimal in the eastern Arab region, as Rodney Wilson noted.<sup>613</sup> He emphasised that a pan-Arab rail network is necessary not only for passenger transport but also for freight. Recently, there have been some shy measures to reactivate the old Hejaz Railway line between Damascus and Amman. Iraq freight trains have also commenced their trips to Aleppo in northern Syria. These attempts are still at the beginning and the existing lines need to be renovated entirely to afford speed railways. However, Lebanon should get involved in any available plan for regional railways network. Lebanon's transit trade would be at stake if its government lagged behind and did not resume a leading position in regional planning. The first step would be achieved by developing a local network connecting the ports of Beirut and Tripoli to the industrial zones and to the borders with Syria.

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<sup>613</sup> Wilson, R, Development of Transport Infrastructure for Inter-state Trade Throughout the Eastern Arab World. In Nonneman, G, *The Middle East and Europe*. op.cit, p. 180.

As for the third factor of production, finance, it is another obstacle for FDI. Indeed, the lack of finance is a problem for domestic investments as well. This problem is directly related to the government's fiscal policy. As long as the Lebanese government keeps borrowing from commercial banks to cover its budget deficits, these banks would be less interested in giving long-term loans at a low-rate interest. The government is crowding out private investments by competing for available finance. However, it can be argued that Lebanon at the moment needs FDI activities that bring foreign capital and that do not use domestic savings. Indeed, the influx of these investments would become easier, even if local finance was not available, once other needed factors of production and other incentives become available.

All the above needed motives for establishing FDI activities in Lebanon might sound confined to industrial organisations, as they are concerned with markets and factors of production. However, these needs apply to investments in other sectors, like financial and non-financial services. FDI interests in the finance sector would increase if Lebanon were to serve a bigger market. The heydays of Lebanon's financial sector were, mainly, a result of the role played by Beirut in serving the wealth generated in the Arab region. Although the role of Beirut as a financial centre that serves the Gulf area was taken over by other services centres in Dubai and Bahrain, Beirut could divert its focus towards countries more in need of a developed financial sector. Here again, Syria should be the focus of Lebanon's financial sector. The opening of the Syrian market to Lebanese financial services would be beneficial for the two countries. The backward financial sector of Syria would not be able to take Syria into a full open-market economy. If the Syrians need a reliable financial sector, they would be better relying on the Lebanese. Historically, Beirut financiers played an important role in funding economic activities in Damascus. As Owen noted, Damascene traders were obtaining their credit letters from Beirut by the mid-19<sup>th</sup> century.<sup>614</sup> The historical background of this research has shown the extent of economic integration that was between the two countries until independence. Under the French mandate, although two separate entities were eventually established, many administrative aspects, like customs, were kept unified. Only when the interests of the bourgeoisie in the two countries went in different ways was this unity abolished. Now that the process of removing barriers between the two countries has been put on the track, the Lebanese financial sector has got the chance to

enter a new market before anyone else. The Lebanese financial sector can attract FDI by selling itself as the most knowledgeable of the Syrian market. Foreign investors with some interest in the Syrian market can then be attracted into joint ventures and mergers with Lebanese financial entities to serve both markets. For a foreign firm, the partnership with a local firm would reduce the risk factor that normally keeps investors away. Apart from Syria, the Lebanese financial sector should start building bridgeheads into Iraq. The country is under sanctions now but eventually will be allowed back into the international community. The expected process of reconstruction would create huge opportunities for the financial sector that gets in first. Jordan, on the other hand, is not a promising place for Lebanon's financial sector as it has its own developed sector. On the contrary, the Jordanian financial sector would be competing with the Lebanese in the Iraqi market. However, if the Lebanese financial entities managed to promote their sector as the most developed in the Levant and sold their knowledge of the Syrian and Iraqi markets in a conducive way, foreign finance companies would prefer to be located in Beirut. This is because Lebanon's capital would provide better access to the Syrian market related to a very special relation between the two countries. In addition, Beirut could still rely on its history in financial services. A foreign investor would be interested in having one branch serving the region in order to cut the cost of operations. In this sense, Beirut should prove that it is the right place to be located in, by working on expanding the market for its financial services into the above-mentioned countries.

- Coherent legal framework for FDI: Accompanying the measures to expand markets and providing competitive factors of production should be a set of measures to establish a conducive legal framework for FDI and administrative reform. All legislative decrees related to foreign direct investments should be combined together in one law after amending the rules that hinder FDI activities. First amongst these decrees is the Legislative Decree 113 of 16<sup>th</sup> September 1983, which imposes severe restrictions on the foreigners' right for ownership of property. If the Lebanese governments fear potential threats to its sovereignty then these fears are simply unjustifiable. The ownership of property does not give the owner the indefinite authorities in exploiting the property. The owner would still have to abide by the laws of the country. The Lebanese government, thus, should look back into this decree and remove all unnecessary obstacles to FDI. Moreover, rules concerning the registration of firms and

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<sup>614</sup> Owen. R, (1981) op.cit, p.98.

obtaining work permits are too complicated. The cost of these procedures is more expensive than other countries.

In addition, the Lebanese government should cut all administrative obstacles that keep foreign investors away. The role of the “inflexible administrators” –the bureaucrats – should be trimmed to prevent them from creating administrative complications to keep their influential status. The cut of red tape would be a double-edged sword, as it would eliminate the outdated trivial rules, on one hand, and reduce the role of the bureaucrats, on the other. The red tape is a time consuming and open-ended process that would frighten investors in a foreign country. It also allows bureaucrats at different levels to impose their ‘hidden-taxes’. In Lebanon, the establishment of the Investment Development Authority of Lebanon (IDAL) to be a one-stop shop for foreign investors has played a little role in attracting investments. The creation of a separate apparatus does not cover the need to modernise the whole system. IDAL was connected straight to the PM’s office, which would interfere to sort problems facing investors, if needed. However, this does not give foreign investors the kind of security they would be looking for. Companies that are coming from the West are used to dealing with systems that are there to stay, rather than persons that come and go. The uncertain future of IDAL after the departure of Hariri is the best example on the hazard involved. Therefore, the whole administrative system needs to be reformed by introducing new rules that cut the red tape, reduce the role of bureaucrats and enhance transparency.

- Political and economic stability: The issues of political and economic instability can have a negative impact on the prospects of attracting FDI activities. The period covered in this research has witnessed a strengthening of the government’s control over the country. Yet, the political stability was hit by infrequent Israeli attacks. Recently, during the mandate of the government of PM Salim Hoss, Israeli troops withdrew from southern Lebanon. Despite optimism, a complete political stability is seen unachievable as long as Lebanon and Syria do not sign peace treaties with Israel. Moreover, the presence of Syrian troops on the Lebanese soil is still considered as a sign of instability in the country. These two factors would contribute to the lack of FDI activities in Lebanon. As for the economic stability, the Lebanese government would have to find the right fiscal policy to get out of the turmoil represented by the huge budget deficit and the growing public debt. Privatisation has been one of the solutions discussed

extensively in Lebanon. This research supports the call for privatisation as far as FDI activities are concerned. The process of privatisation, once commenced, would be a major incentive for the flow of foreign capital, particularly from the EU. Multinational firms are interested in big projects that allow the exploitation of economics of scale. It was proved through the B.O.T. projects, which developed the mobile phone network, that involving the private sector did not harm the economy. The problems that erupted between the operating firms and the government are due to misunderstanding resulting from the lack of proper legal framework. Therefore, the problem is not in the concept of privatisation, but in the performance. Nevertheless, the two private firms operating the mobile phone network have boosted the government's revenues from the telecom sector, and provided a very modern service. The proposed conversion of the current B.O.T. contracts into licences is expected to bring over US\$ 1.5 bn. Yet, the introduction of a third mobile phone company might bring more capital into the Treasury. In any case, the government would be receiving a much-needed inflow of capital to help in repaying the astronomical public debt. The process of privatisation should start as soon as possible, accompanied by all administrative reforms needed, to attract foreign capital and relieve the government of some public sector utilities that are draining government's resources.

Therefore, privatisation, expanding the market (particularly towards Syria), the provision of cheaper factors of production and administrative reform should be the bases for the Lebanese government's policy to attract FDI activities. The government should get the private sector more involved in operating the utilities and focus more on establishing a helpful environment for FDI activities, in which free competition is guaranteed. It should also seek markets for the locally produced goods, by signing treaties securing free trade. Most important is a full free trade with Syria and the accomplishment of the Euro-Mediterranean partnership agreement. The government should also work to provide factors of production at a competitive cost. Once these provisions exist, Lebanon's comparative advantages would rise significantly.

Whether direct investments would come from the EU or other sources would not be a matter of concern for Lebanon. The inflow of foreign capital would be always welcomed in a country desperate for cash. However, firms coming from the EU might have comparative advantages in operating in Lebanon. The factors of proximity and



history would have positive roles. This thesis has proven that the history of business activity between Europe and Lebanon showed that the latter has attracted FDI inflows from the former at certain periods of time. French investments in the silk industry during the 19<sup>th</sup> century and the services sector during the mandate period testify to this argument. As for the EU's role in encouraging FDI activities by EU private businesses in Lebanon, this can be more active. Within the Euro-Med process, the EU is attempting to instigate a process of economic development in the southern countries. Yet, the EU's role in bringing in private investments is very slim. The MEDA Programme arranges for finding EU business partners for small and medium-sized Southern businesses. Through its partnership agreements, the EU also provides grants for economic development in these countries, which include funds for upgrading the competitiveness of local firms to make them attractive joint venture partners and improving the legal, financial and administrative environments for investment in general. The EIB provides soft loans as well. However, the EU can get more involved in seeking private direct investments from EU countries into southern countries like Lebanon. Although the EU does not have the authority to force private businesses to operate in Lebanon, it could convince them. The EU can allocate funds for supporting joint ventures between EU firms and local firms. Obviously, local industries, like the case of Lebanon's, are in short of finance. The EU should provide long-term soft loans to projects involving EU firms in countries like Lebanon. This way, the EU can fulfil some of the needs of these countries, and play the role expected from it.

Yet, it has to be said that the role of the EU in encouraging EU-private direct investments into Lebanon will remain an auxiliary, rather than a pivotal, factor. The EU can, and should, provide all the assistance suggested above, in order to encourage FDI activities. However, it is the Lebanese government and the local business community that need to cooperate to put their house in order to attract FDI. The disadvantages are embodied in the host country – Lebanon, and it is the hosts that are expected to make their country a more attractive destination for investments.

In light of the above, further areas of research, that this thesis has touched upon, can be recommended. Firstly, an extensive investigation of Lebanon's potential to develop its manufacturing industry is needed. To adopt the argument which considers that Lebanon's chance to prosper lies in services only would be very short sighted.

Meanwhile, to suggest that any of the existing manufacturing industries in Lebanon can prosper and achieve competitiveness in international markets would be based on unfounded optimism. The Lebanese government, therefore, has to look for Lebanon's niche in manufacturing, thereafter supporting the private sector by all the means available to develop this potential. This would serve the aim of attracting FDI, as investors would be interested in forging joint ventures with successful businesses.

Secondly, the issue of the structural adjustment of small- and medium-sized firms needs to be addressed. Local firms need to consider the options of mergers and acquisitions as one way to achieve competitiveness. Foreign capital would gravitate towards these firms once they have a substantial share of the market.

Thirdly, Lebanon, like many other neighbouring countries, needs to offset the disadvantages of having a limited market size. Further research should address the advantages of dismantling trade barriers between Arab countries and establishing customs unions. Economic integration would serve as an incentive for foreign investment: it would create bigger markets and achieve mobility of labour and capital. Ironically, as Louis Blin noted, for the sake of achieving bigger markets, multinational corporations are "enthusiastic supporters of Arab Unity!!"<sup>615</sup>

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<sup>615</sup> Blin. L, French Investment in the Arab World. In Ayubi. N, The Political Economy of Relations Between Europe and the Middle East/North Africa (Reading: Ithaca, 1995), p. 271.

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### **Interviews:**

(The official titles of the interviewees are the ones they held at the time these interviews were conducted - 1998)

#### Lebanese Economists

- Dr. Kamal Shehadi.
- Dr. Elie Yashoui.
- Dr. Kamal Hamdan.
- Dr. Antoine Haddad.

#### Lebanese Government Officials

- Mr. Mazen Hanna, Economist. Advisor to the Minister of Finance. Lebanon
- Mr. Hilmi Ghandour, Senior Advisor to the Minister of Economy and Trade. Lebanon.
- Mr. Kamal Hayek, Engineer and Financial Analyst. Investment Development Authority of Lebanon (IDAL).
- Mr. Al-Fadl Shalak, Ex-Chairman of the Council for Development and Reconstruction (CDR), and ex-Minister of Telecommunication (Interviewed twice in 1997 and 2000).

#### Private Sector Representatives (Lebanon)

- Mr. Saad e-Din el-Ouyaini, General Director of the Lebanese Industrialists' Committee.
- Dr. Fadi Osseiran. General Manager of Banque D'Affaires Du Liban Et D'Outre-Mer sal.

#### Lebanese lawyer:

- Dr. Nasri Antoine Diab. Member of the Institute of Petroleum (London), and lecturer at the Faculty of Law, University of Saint Joseph (Beirut).



Official Representatives of European Governments and Delegations

- Mr. Paul Khawaja. Commercial Officer at the British Embassy. Beirut.
- Mr. Alexis Nassan. Representative of the Delegate of German Industry and Trade. Beirut.

Representative of British Companies in Lebanon

- Mr. Roy H. Gardner. Assistant General Manager at Schroders. Beirut.
- Mr. Michael Wright. General Manager at Spinneys. Inchcape Retail Services, An Inchcape Associate Company.
- Mr. Ken Gilder. Project Manager. Kvaerner Construction International. Beirut (Sports Complex).
- Mr. Dominic Herbert. The Head of Near East at Flemings. Beirut.

Interviewees in London

- Mr. Jim Sillars, Assistant to the Secretary-General. The Arab-British Chamber of Commerce.
- Ms. Elizabeth Mottershaw, MEED. Lebanon desk.
- Mr. Andrew Gilmour. Director M.E & N.A at the EIU.
- Mr. Sinclair Road. Senior Consultant at COMET.
- Mr. Philip Khoury. Strategy Analyst. Flemings.

